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TAX REFORM PROPOSALS—XXII

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

OCTOBER 1, 1985

(Impact of the tax plan on the Insurance Industry)

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TAX REFORM PROPOSALS—XXII

TUESDAY, OCTOBER 1, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:36 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Packwood (chairman) presiding.

Present: Senators Packwood, Chafee, Heinz, Grassley, Long, Bentsen, Matsunaga, and Bradley.

[The press release announcing the hearing follows:]

[Press Release No. 85-068, Thursday, Aug. 9, 1985]

TAX REFORM HEARINGS BEFORE THE FINANCE COMMITTEE TO CONTINUE IN SEPTEMBER AND OCTOBER

Further hearings before the Senate Committee on Finance on the President's tax reform proposal will continue in September and October, Chairman Bob Packwood (R-Oregon) announced today.

"The Committee made significant progress in its tax reform hearing schedule in June and July," Senator Packwood stated. "Although the Committee will focus much of its attention on deficit reduction in the month of September, tax reform hearings will continue and will take us further toward our goal of getting a tax reform bill to the President before the end of this session of Congress."

The hearings announced by Senator Packwood today include:

On Tuesday, September 24, the Committee will hear from public witnesses on the impact of tax reform on tax-exempt bonds.

On Thursday, September 26, public witnesses will present their views on the impact of the President's tax reform proposal on financial institutions and on the mining industry.

On Tuesday, October 1, the Committee will receive testimony on the impact of the tax plan on the insurance industry.

On Wednesday, October 2, witnesses representing the public will present testimony on the projected effect that tax reform will have on American business generally and, in addition, its impact on the foreign tax provisions.

On Thursday, October 3, the Committee will consider the views of public witnesses on the impact of the President's tax reform proposal on our nation's regulated industries, as well as those provisions relating to the United States' possessions and its territories.

All of the hearings scheduled by the Committee will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

Senator LONG. The hearing will come to order.

I was asked to start the hearing since Mr. Packwood and other Republican members are at the White House.

We will start today's hearing with a panel consisting of Mr. William J. Anderson, Mr. Peter Lardner, and Mr. Andre Maisonpierre.

According to our schedule, Mr. Anderson is to go first.

STATEMENT OF WILLIAM J. ANDERSON, DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY DR. NATWAR M. GANDHI, GROUP DIRECTOR, TAX POLICY, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. ANDERSON. Thank you very much, Mr. Chairman.

I'd like to introduce the gentleman to my left, Dr. Natwar Gandhi, who was really the principal on this report that we prepared for this committee that was presented to it this past March entitled "Congress Should Consider Changing Federal Income Taxation of the Property Casualty Insurance Company."

I think it's important for you to recognize the credentials that Dr. Gandhi brings to the work and the weight that you perhaps might want to give to our analysis. With your permission, sir, I will read a brief biography of him.

He is Group Director for Tax Policy in the General Government Division of GAO in charge of major projects examining taxation of financial intermediaries, including insurance companies and banks.

Dr. Gandhi regularly briefs and testifies before the tax-writing and other committees of the Congress. A well-recognized authority on taxation of the insurance industry, he has addressed seminars at the Hartford Institute on insurance taxation, and other insurance industry meetings on tax issues. Previously, he taught at several universities, including the University of Pittsburgh where he was on the faculty of the Graduate School of Business, and has held consulting assignments with corporations such as IBM and Jones & Laughlin Steel.

Currently, he also teaches at the University of Maryland as an adjunct professor in the College of Business Administration and Management, and regularly conducts executive development seminars in finance and accounting for several business and industry organizations.

Dr. Gandhi has published numerous papers and professional journals on accounting and taxation matters. I think the important thing is that Dr. Gandhi is recognized as an expert in these matters, I'm sure by the gentlemen on the panel here with me as well as others in the room.

Now with your permission, sir, I would like to enter the full statement in the record, recognizing your desire to keep things moving. I have about a 5-minute abbreviated version, if you will let me read that.

Senator LONG. Yes, sir; go ahead.

Mr. ANDERSON. Thank you.

We are pleased for the opportunity to assist the committee in its deliberations on taxation of the insurance industry. We have had an active interest in this area for the past 6 years. Earlier in 1985, we issued the report I spoke about earlier. Today, I will focus on the questions discussed in that report. However, we will be pleased to answer whatever questions you may have on the taxation of the life insurance industry as well.

We believe that the Congress should reexamine several aspects of the Tax Code dealing with property/casualty insurance companies. Before explaining why we believe certain parts of the Tax Code should be reexamined, I'd like to provide some background information on the property and casualty insurance company pricing strategies, a financial overview of the industry, and the impact on the industry of certain current tax provisions. I would also like to comment briefly on the consolidation of property/casualty companies with parent companies that are not in the insurance business.

A property/casualty company derives its income from underwriting gains; that is, the excess of premiums over claims and expenses; and investment gains. The ability to offset underwriting and investment income can play an important role in a company's pricing strategy. For a number of years, many companies have been willing to charge lower premiums to compete for certain insurance lines, even though they will have ratios of claims and expenses to premiums in excess of 100 percent. In 1984, for example, claims and expenses ran at 117.8 percent of premiums. So it's obvious that they are operating at a loss on that part of their business.

The companies expect to make up the premium shortfall through investment income. Through the incremental volume of premiums resulting from this pricing approach, companies are able to generate a larger amount of net cash flow which they can then invest to earn additional investment income. For instance, in 1983 when the industry had a combined ratio of claims and expenses to premiums of about 112 percent, which produced an underwriting loss of about $11 billion, it still had a net gain of about $9 billion, and generated a total of about $12.1 billion in net cash flow.

Let me give you a financial overview of the industry in its entirety. We developed one that reflects financial data for the 10-year period 1975 through 1984. We show on the table before you that while property/casualty companies had about $46 billion in underwriting losses from 1975 through 1984, they had about $121 billion in investment gains during that period, resulting in a net gain of about $75 billion. From 1975 through 1984, Federal income taxes were a negative $125 million. I'm not saving there is anything necessarily wrong with that. There are advantages of the code—features of the code that the companies took advantage of.

Our analysis of the foregoing financial data gives some insight into how current tax policy affects the property/casualty insurance company. As a result of certain tax advantages, many property/casualty companies have not paid Federal income taxes for a number of years, and, in fact, have qualified for refunds or the ability to carry back or carry forward losses for tax purposes.

We found from a study of the top 29 groups of companies, representing more than 60 percent of the industry's premiums, that as of December 31, 1984, these groups had loss carryforwards of almost $6 billion. This figure should be kept in mind in estimating the expected future revenue that will actually be realized from the industry under any new tax proposals. To the extent that companies would have these loss carryforwards to offset any increases in taxable income, there would not be an effect on the Treasury.

In addition to the tax deferrals resulting from the treatment of loss reserves, the treatment of acquisition expenses, and the protection against loss account, property/casualty companies can also use tax provisions available to other taxpayers. These tax provisions include excluding interest income from tax-exempt securities and deducting 85 percent of the dividends received from domestic corporations. Between 1975 and 1982, about 60 percent of the gross investment income of all property/casualty companies was excluded from taxable income because of these provisions.

Now these tax losses make these property/casualty companies attractive merger partners for other industries and companies generating large profits.

In addition, the basic liquidity and constant cash flow of a property/casualty company assures that funds will be available to a parent corporation for various investments. Even in the year of record underwriting losses in 1984, the property/casualty industry still had a net cash flow of about $11.8 billion.

Table 2 shows the 20 largest groups of property/casualty companies broken out by those with a noninsurance parent company and those that stand alone or have life insurance affiliates. This is on page 4 of the full statement.

Table 2 shows that of the 20 largest property/casualty groups, the six with noninsurance parent companies had large net losses for tax purposes—I want to emphasize for "tax purposes"—as shown by the negative income taxes. Of the $726 million in negative income taxes generated by the six noninsurance affiliated property/casualty groups, nearly all, $714 million was used to offset tax liabilities of the parent companies.

It seems clear the property/casualty companies can become important acquisitions for noninsurance corporations.

We indicated in our report on the taxation of the industry that the Congress should reexamine three areas of the code. First, we concluded that the present practice of deducting in the tax year the full undiscounted amount of future estimated settlement costs overstates the loss reserve deduction. We suggested that the Congress consider amending the Tax Code to provide that for tax purposes loss reserves be discounted in calculating the loss reserve deduction. The administration's proposals would aim to strike at that same problem. There is some controversy and we have our own doubts as to whether their specific proposal is the way to address the problem.

Second, we concluded that the present treatment of acquisition expenses fails to match expenses and revenues. Currently, the Tax Code permits all acquisition expenses to be deducted immediately, even though the premiums associated with those expenses are spread over the life of the contract. In this case, we suggested that the Congress consider amending the Tax Code to provide that acquisition costs be allocated over the life of related contracts so that these costs are matched with premium payments generated by the contracts.

Third, we concluded that the protection against loss account may not protect mutual companies against catastrophic losses, the purpose for which they were originally established, because the money in the account is not earmarked for that purpose. Thus, if a catastrophic loss were to occur, the account does not necessarily ensure the company's ability to satisfy its contract obligations. In this case, we recommended that the Congress consider whether or not this special tax preference for mutual property/casualty insurance companies should be retained in its present form. The administration proposal also addresses this problem, and we agree with their position on it.

In conclusion, Mr. Chairman, the financial information we have presented indicates that the property/casualty insurance industry has paid a relatively small share of its net income in Federal income taxes in recent years. While we are not in a position to comment on what might be an appropriate Federal tax burden for the industry, we do believe that the Congress should consider amending the Tax Code along the lines suggested in our report. And keep in mind the distinction between losses that are shown for tax purposes and the real economic health of the industry as it has evolved overtime.

Let me stop right there, sir, and give the other panelists a chance to speak.

Senator LONG. I want to ask you a question before we go to the other panelists.

Mr. ANDERSON. Yes, sir.

Senator LONG. I understand something about loss reserves. I've never represented a company in that respect, but I know lawyers who have. My understanding is that a company will ask the lawyer to evaluate the potential loss under a claim. The lawyer's credibility would be hurt if he said the claim could cost you $100,000 and it actually costs you $500,000. Thus, he might evaluate the claim on the high side. He might say $700,000 is the highest he thinks you need to worry about where he probably would not go over $100,000 if he had to guess the actual outcome.

Of course, he has to be in a position to say that his honest opinion is that the recovery conceivably could go that high even if it is highly, unlikely.

The lawyer's estimate serves as a basis for the company to put that estimate on its books as a reserve for the claim even if the actual claim is likely to be several times less.

How would you go about fixing some lesser figure than the lawyer's estimate?

Mr. ANDERSON. Well, one thing to keep in mind, sir, that the scenario that you described, in fact, really isn't what has been the case in recent years. The insurance companies will point out that in fact the reserves that they have been establishing have not proven sufficient to pay the claims. That, in fact, they put $700,000 and it ended up to be $1 million because the courts out there in some lines of insurance are acting in ways that they did not anticipate.

One of the arguments against the discounting proposal that we present is that in fact there has been discounting because they have been underestimating those reserves.

But back to your question, there is experience on this. In other words, to me, the best guide in what to expect down the road has to be what the experience has been with respect to medical malpractice in the past or auto liability and that sort of thing. Insurance companies can produce tables that will show you from the year a policy is written what part of the claims will be paid in the first year, the second year, the third year, the fourth year, based on historical experience. So it's much more of a science than, you know, you would expect.

They have proven correct because of all this and they are going to have to make some adjustments. And I presume that the insurance companies are hard at work trying to factor in this new unexpected experience in the courts as they calculate the reserves that they actually require for medical malpractice, for example.

Senator LONG. Are you saying that reserves are on the low side of actual payments rather than on the high side?

Mr. ANDERSON. From that standpoint, they will argue that, in fact, yes, the reserves that have been established have proven to be for certain product lines lower than they should have been because of these unexpected generally court settlements—workmen's comp, medical malpractice, and general liability.

Senator LONG. I can understand that for malpractice.

Mr. ANDERSON. Yes, sir; now medical malpractice, I ought to point out that I spoke of that ratio of expenses to premiums. In the medical malpractice area, they have been experiencing 160 percent. It's costing them $1.60 to pay off on a dollar premium that they receive so it's highly unprofitable business for them.

Senator LONG. Do you have a solution to that? Are the reserves understated?

Mr. ANDERSON. Well, let me put it to you this way. The reserves that currently exist are understated. I would expect that that will be a self-correcting situation as the industry establishes improved methods of anticipating what future claims will be. That's really unrelated to the issue that we bring here today that points up an improved way to establish the size of the reserve accounts.

Senator LONG. Thank you very much.

The next witness is Mr. Peter Lardner.

[The prepared written statement of Mr. William J. Anderson follows:]

UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
Expected at 9:30 a.m.
Tuesday, October 1, 1985

STATEMENT OF

WILLIAM J. ANDERSON, DIRECTOR

GENERAL GOVERNMENT DIVISION

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ON

THE TAXATION OF THE PROPERTY/CASUALTY INSURANCE INDUSTRY

Mr. Chairman and Members of the Committee:

We are pleased for the opportunity to assist the Committee in its deliberations on taxation of the insurance industry. We have had an active interest in this area for the past 6 years. In 1981 we submitted a report to the Congress on taxation of life insurance companies. Earlier in 1985 we issued to this Committee a report on taxation of the property/casualty insurance industry. Today, I will focus on the latter. However, we will be pleased to answer whatever questions you may have on the taxation of the life insurance industry as well.

Mr. Chairman, we believe that the Congress should reexamine several aspects of the tax code dealing with property/casualty insurance companies. These aspects include the deduction for loss reserves, the deduction for acquisition expenses, and the protection against loss account. Before explaining why we believe certain parts of the tax code should be reexamined, I would like to provide some background information on property and casualty insurance company pricing strategies, a financial overview of the industry, and the impact on the industry of certain current tax provisions. I would also like to comment briefly on the consolidation of property/casualty companies with parent companies that are not in the insurance business.

PROPERTY/CASUALTY COMPANY PRICING STRATEGIES

A property/casualty company derives its income from underwriting gains (the excess of premiums over claims and expenses) and investment gains. Because of investment gains, a property/casualty company can still have net income even though its premiums alone are not large enough to cover claims and expenses. Thus, even though a company has a ratio of claims and expenses to premiums in excess of 100 percent, which normally would indicate the company had suffered an operating loss, it may well have a positive net income.

The ability to offset underwriting and investment income can play an important role in a company's pricing strategy--that is, the amount of premiums it charges for the insurance that it offers. For a number of years, many companies have been willing to charge lower premiums to compete for certain insurance lines, even though they will have ratios of claims and expenses to premiums in excess of 100 percent. (For example, in some major lines of business, such as medical malpractice and other liability, these ratios have been more than 160 percent.) The companies expect to make up the premium shortfall through investment income. Through the incremental volume of premiums resulting from this pricing approach, companies are able to generate a larger amount of net cash flow which they can then invest to earn additional investment income. For instance, in 1983 when the industry had a combined ratio of claims and expenses to premiums of about 112 percent, which produced an underwriting loss of about $11 billion dollars, it still had a net gain of about $9 billion and generated a total of about $12.1 billion in net cash flow, as reported by Best's Management Reports.

In past years investment gains, in the aggregate, have exceeded underwriting losses by a fairly wide margin. However, the gap has been narrowing in recent years and disappeared in 1984, when underwriting losses for the industry were $19.4 billion, and the investment gain was $17.9 billion. Many companies have reacted to this situation by raising premiums.

FINANCIAL OVERVIEW OF THE PROPERTY/CASUALTY INDUSTRY

We developed a financial overview of the property/casualty insurance industry by studying financial data for the 10-year period 1975 through 1984. We obtained these data from Best's Aggregates and Averages. While Bests' reports omit figures for many small or new companies, we believe that the data are sufficiently representative of the overall financial results of the property/casualty industry.

In tables 1 and 2 we show sources of income, broken out by underwriting gains, investment gains, and total gains. We also show disposition of income, broken out by the increase in surplus, dividends to stockholders, and the combined total. Federal income taxes are also shown.

We show in table 1 that, while property/casualty companies had about $46 billion in underwriting losses from 1975 through 1984, they had about $121 billion in investment gains during this period, resulting in a net gain of about $75 billion for those years. From 1975 through 1984, federal income taxes were a negative $125 million, a rate of - 0.2 percent of the net gain.

Table 1

All P/C Companies - Consolidated Basis
1975 through 1984
(in billions of dollars)

Underwriting gains (loss)	Investment gains	Net gains	Federal income tax	Percentage of federal income tax to net gains
($45.8)	$121.0	$75.2	($0.125)	(0.2)

Table 2 shows that about $48 billion of property/casualty companies' income from 1975 through 1984 went to an increase in surplus, and $18.5 billion went to stockholders in the form of dividends.

Table 2

All P/C Companies - Consolidated Basis
1975 through 1984
(in billions of dollars)

Increase in surplus	Dividends to stockholders	Total
$47.8	$18.5	$66.3

Tables 1 and 2 have shown that from 1975 through 1984 the industry as a whole, in spite of its underwriting losses, had positive net gains, yet had a negative federal income tax rate in relation to its net gains.

IMPACT OF CURRENT TAX PROVISIONS

Our analysis of the foregoing financial data gives insight into how current tax policy affects the property/casualty insurance industry. As a result of certain tax advantages, many property/casualty companies have not paid federal income taxes for a number of years and, in fact, have qualified for refunds or the ability to carry back or carry forward losses for tax purposes. We found from a study of the top 29 groups of property/casualty companies representing more than 60 percent of the industry's premiums, that as of December 31, 1984 these groups had carryforwards of almost $6 billion. This figure should be kept in mind in estimating the expected future revenue that will actually be realized from the industry under any new tax proposal.

In addition to the tax deferrals resulting from the treatment of loss reserves, the treatment of acquisition expenses, and the protection against loss account, property/casualty companies can also use tax provisions available to other taxpayers. These tax provisions include excluding interest income from tax-exempt securities and deducting 85 percent of the dividends received from domestic corporations. Between 1975 and 1982, about 40 percent of the gross investment income of all property/casualty companies was from tax-exempt investments. The dividends received deduction during this period represented about 20 percent of the gross investment income of the companies.

While we presented and discussed these facts in our report, we did not recommend any changes in the application of the exclusion of tax-exempt interest or the dividend received deduction to property/casualty companies. We limited our study to those provisions of the tax code which applied only to property/casualty companies.

CONSOLIDATION WITH NON-INSURANCE PARENTS FOR TAX PURPOSES

Special provisions of the Internal Revenue Code enable property/casualty companies to report losses for tax purposes even when they are operating profitably. These provisions make them attractive subsidiaries to companies seeking to reduce their tax liability. For example, property/casualty companies are required to calculate loss reserve deductions under state regulated accounting rules, which reduce a company's taxable income. Furthermore, under these same state regulated accounting rules, companies may deduct expenses associated with the sale and renewal of insurance policies, even though they are not required to recognize related premium income until is earned. This also reduces taxable income.

If a property/casualty company were independent it might not be able to use these losses immediately for tax purposes. However, if the property/casualty company is owned by a non-insurance parent company all of the losses may be used to offset taxable income of the parent company. If the property/casualty company is owned by a life insurance company the losses that may be used by the parent are limited to the lesser of 35 percent of the subsidiary's losses or 35 percent of the parent's taxable income.

In addition, the basic liquidity and constant cash flow of a property/casualty company assures that funds will be available to a parent corporation for various investments, such as investment in tax-exempt securities. Even in the year of record underwriting losses in 1984, the p/c industry had a net cash flow of $11.8 billion.

Table 3 shows the 20 largest groups of property/casualty companies broken out by those with a non-insurance parent company and those that stand alone or have life insurance affiliates.

Table 3
Twenty Largest P/C Groups - 1984
(in millions of dollars)

	Number	Percentage of industry premiums	Federal income tax
With non-insurance parent	6	15%	($726.5)
Others	14	38	(536.6)
Total	20	53%	($1,263.1)

Table 3 shows that, of the 20 largest property/casualty groups, the 6 with non-insurance parent companies had large net losses for tax purposes (as shown by negative income taxes). Of the $726 million in negative income taxes generated by the six non-insurance affiliated property/casualty groups, nearly all ($714 million) was used to offset tax liabilities of the parent companies.

It seems clear that property/casualty companies can become important acquisitions for non-insurance corporations. However, the studies we made were inconclusive as to what effect consolidation with non-insurance parent companies had on the property/casualty insurance subsidiary. For example, consolidation with a non-insurance parent did not seem to ensure that the consolidated property/casualty company would grow at a faster rate nor did it seem to have a positive effect on the company's rate of return.

AREAS OF PROPERTY/CASUALTY INSURANCE TAXATION NEEDING CONGRESSIONAL REEXAMINATION

We indicated in our report on the taxation of the property/casualty insurance industry that the Congress should reexamine three areas of the tax code.

These areas are

- --the deduction currently allowed for loss reserves;
- --the practice of currently deducting all of the expenses associated with the sale and renewal of insurance policies; and
- --the protection against loss account, which defers a portion of a mutual company's income to provide a cushion for catastrophic loss.

Our conclusions and recommendations in each of the three areas were as follows:

First, we concluded that the present practice of deducting in the tax year the full (undiscounted) amount of future estimated settlement costs overstates the loss reserve deduction. We suggested that the Congress consider amending the tax code to provide that for tax purposes loss reserves be discounted in calculating the loss reserve deduction. We further stated that the discount rate should be based on a moving average of each company's pre-tax net return on its investment portfolio.

We estimated discounted loss reserve levels at several discount rates for 1980-82 (holding all other factors constant) and the additional tax liability that would have resulted. If a hypothetical discount rate of 7 percent had been used by all companies in 1982, the deductions taken would have been reduced by about $1.3 billion, and tax liabilities would have been greater by about $613 million.

Second, we concluded that the present treatment of acquisition expenses fails to match expenses and revenues. Currently, the tax code permits all acquisition expenses to be deducted immediately, even though the premiums associated with these expenses are spread over the life of the contract. In this case we suggested that the Congress consider amending the tax code to provide that acquisition costs be allocated over the life of related contracts so that these costs are matched with premium payments generated by the contracts.

If acquisition expenses were allocated when revenue is recognized, then taxable income would increase. We estimated the additional tax liability that would have accrued for the years 1980-82 if this change had been made and everything else had remained the same. Based on these assumptions, the additional tax liabilities would have been approximately $164 million in 1982.

It is important to note that even if both of these changes in the tax code had been effective, the Treasury would have received only a portion of our estimated amounts of additional taxes. Some companies were showing losses for tax purposes and had large outstanding loss carryforwards. Furthermore, companies might shelter more of their investment income and thereby mitigate the tax impact of any increases in income.

This could be done through increasing their holdings of tax-exempt securities or equity securities of domestic corporations.

Third, we concluded that the protection against loss account may not protect mutual companies against catastrophic losses because the money in the account is not earmarked for that purpose. Thus, if a catastrophic loss were to occur, the account does not necessarily ensure the company's ability to satisfy its contract obligations. In this case, we recommended that the Congress consider whether or not this special tax preference for mutual property/casualty insurance companies should be retained in its present form.

CONCLUSION

In conclusion, Mr. Chairman, the financial information we have presented indicates that the property/casualty insurance industry has paid a relatively small share of its net income in federal income taxes in recent years. While we are not in a position to comment on what might be an appropriate federal tax burden for the industry, we do believe that the Congress should consider amending the tax code along the lines suggested in our report. In our view, the changes would result in a better match of the industry's revenues and expenses and represent a more rational approach to its taxation.

This concludes my prepared remarks. We would be glad to answer any questions you may have.

STATEMENT OF PETER LARDNER, CHAIRMAN, AMERICAN INSURANCE ASSOCIATION, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, BITUMINOUS INSURANCE CO., ROCK ISLAND, IL

Mr. **Lardner**. Mr. Chairman, my name is Peter Lardner. I'm president and chief executive officer of Bituminous Insurance Cos.; chairman of the American Insurance Association. I'm pleased to have the opportunity to appear today.

Our trade association is an organization that writes almost one-third of all property and casualty premiums in the United States. My remarks will focus on the potential impact of the administration's tax proposal on the casualty insurance industry. That impact, in a word, would be devastating.

Although my remarks will be directed at one most onerous element of the proposal, I wish to note that our association agrees with the other trade associations of the property/casualty insurance industry that no case has been made for any of the administration's proposed changes in our provisions of the Internal Revenue Code.

The administration proposes a method of accounting which has the effect of reducing the deductions allowed insurance companies for our incurred losses on property and casualty risks. This proposal known as qualified reserve account, permits a deduction for only part of an insurer's unpaid losses; that is, claims incurred, but not yet paid. In contrast, the current law follows State regulatory accounting and recognizes the full amount of losses as liabilities and deductions in the year in which they occur.

The QRA proposal is seriously flawed. If enacted, it would establish unsound tax policy. It would produce adverse social and economic impact. Among the more serious flaws in the QRA proposal are the following: It would tax investment income twice, once when the income is earned and again when claims are paid and the QRA is released; it would tax income from State and municipal investments at the full corporate rate. For sound public policy reasons, the Congress has mandated that such income should be exempt from Federal taxation.

It would force casualty insurers to increase their premiums. Such increases are anticipated in the administration proposal. These are nothing more than a hidden tax on individuals and businesses.

QRA would further disadvantage the competitive position of the American insurance industry vis-a-vis foreign insurers, adding to the country's already troublesome balance of trade deficits.

It's founded in part on a theoretical concept of attempting to equalize the tax treatment of insured and the uninsured. And it creates the incentives for business to go without insurance and to assume additional risks both to itself and to its claimants.

It would further deplete our industry's surplus, thereby worsening the capacity of our industry to meet insurance needs in the coming year. It might very well increase the risk of insurer insolvencies by establishing lower reference points for loss reserves.

It would impose what is effectively a cash method of accounting on the unpaid losses of insurers at a time when the administration has launched a strong attack against the use of cash method of accounting in general.

It would add considerable additional complexity to the tax system, requiring a literal multitude of new interpretatives, regulations and placing our industry in a position of having to operate years without guidance.

In a report to your committee, the General Accounting Office has attacked the QRA and advanced their own proposed change in the taxation of casualty insurers. We contend the GAO proposal is similarly flawed. In our written statement submitted for the record today our views are more fully set forth with respect to both of these proposals.

We feel the present tax law applicable to the property/casualty business is fair, appropriate, and sufficient. Yet, we are told that changes will be made. Onerous as those changes may be, the member companies of the American Insurance Association have joined the other four property/casualty insurance industry trade associations in endorsing an alternative proposal that would address some of the tax policy concerns of both the Government and the industry while at the same time substantially increasing the industry's taxable income. The revenue offset proposal, which will be described in more detail by other witnesses, matches a specified percentage of the insurer's unearned premium reserves with related acquisition costs. It would produce the same revenue, but the joint committee estimated it would be raised by the Treasury proposal over the 5-year period.

We believe it's critical you examine and reflect on the real business world, business and social implications, that would flow from the proposals before you. We trust that you will consider the industry's supported proposal instead of the administration's proposal.

We would be more than happy to respond to questions.

Senator LONG. Thank you.

[The prepared written statement of Mr. Lardner follows:]

WRITTEN STATEMENT BY THE AMERICAN INSURANCE ASSOCIATION

The American Insurance Association is a trade association representing 178 property-casualty insurance companies, which are predominantly organized as stock companies. The member companies of AIA had a total premium volume in 1984 of $39.3 billion or 33% of the $118 billion direct premiums written in the United States. The member companies write all types of personal and commercial coverage.

The hearing notice stated the Committee's desire to receive testimony regarding President Reagan's proposal for comprehensive tax reform as it would affect the insurance industry. Specifically, the Administration's tax proposals and other legislative recommendations have recently called the current tax treatment of property-casualty insurance companies into question. We will focus our remarks on the impact of these specific proposals, which would be, in a word, devastating.

The Administration has promoted its tax revision proposals on the grounds that they would simplify the tax laws and make them more equitable and efficient. These appealing claims are extended to the proposals to change the six-decade-old tax rules for property-casualty insurance companies. The General Accounting Office ("GAO"), even while criticizing these proposals, advanced its own plan to revise property-casualty taxation, claiming that its proposals would better measure the income of property-casualty insurance companies. We disagree with both sets of proposals. We flatly believe that neither of them can meet the stated goals of fairness, simplicity, and economic growth.

The most significant proposals for the property-casualty industry, those that affect all members of ther industry, are those which would reduce companies' deducations for incurred losses. The Administration proposes a "Qualified Reserve Account" (or "QRA") approach, which in effect permits a deduction for only part of these incurred losses. On the other hand, GAO proposes to permit the full amount of such losses to be deducted, but to allow the deduction initially in part and spread the remainder over time.

We believe that both QRA and the GAO proposals would result in unfair and unwarranted tax increases at a time when the industry cannot afford further strain on its surplus. Further strain on the industry's surplus will make the task of providing adequate insurance protection to families and business even more difficult. It is these families and small or emerging businesses who must have insurance protection because they cannot afford the exposure to large losses on their own. Also, any increased costs to the customer will disadvantage the U.S. insurance industry competing in the world market, and will result in more U.S. risks being insured abroad.

In contrast, the existing rules of the Internal Revenue Code do not jeopardize the financial standing of the industry in the way QRA and GAO would. Rather, the Code follows public reporting and state regulatory accounting principles in recognizing the full amount of an insurer's losses as liabilities, and deductions, in the year they are established. Based on published financial reports, current law measures an insurer's income by matching losses with associated premium income.

We will now proceed to discuss the QRA proposal in detail. We will follow that with our specific comments on the GAO's proposal, and then focus on a series of practical, economic and business concerns which counsel against adoption of either proposal. We will then turn to a discussion of some general principles of sound tax policy which we would recommend to the Committee as guidelines for an examination of existing law or any alternative tax proposal. A final comment will touch on the Administration's proposal to change the tax treatment of structured settlement annuities, a corollary initiative that we consider unwise.

The Administration Proposal advocates that property-casualty companies be required to use the complex QRA mechanism in accounting for their loss reserves. This mechanism is nothing more than an elaborate device by which to impose cash accounting on property-casualty companies. If adopted, it effectively would abandon any effort to match the revenues and expenses of property-casualty companies, and would seriously mismeasure their income for tax purposes.

The QRA proposal, unlike current law, would limit a property-casualty company to deducting only an initial addition to its reserve for losses incurred during a taxable year. As a practical matter, the deductible initial addition to each year's QRA would be the present value, at the time of the addition, of the insurer's newly inccurred losses, generally computed by discounting such losses at the company's after-tax rate of return on portfolio investments. This initial addition, however, would be limited to the company's insurance reserves as reported on its annual statement filed with State regulators. Thereafter, the company's reserve account would be required to be augmented each year by additional amounts, also based on the company's after-tax portfolio rate of return. In contrast with the initial addition to the QRA, however, no deduction would be allowed for any such subsequent addition. At the time a claim was paid, the entire reserve—including both the initial addition for which a deduction was allowed, and any subsequent addition to the reserve for which no deducation had been allowed—would be includible in income, and the company would be permitted to deduction for payment of the claim.

In comparing property-casualty insurance company tax treatment with that of other business enterprises, the application of QRA is inequitable. Under the QRA method, investment income of a property-casualty insurance company is taxed twice. Investment income is taxed once as it is earned, and the after-tax portion is taxed again when the claims are paid and the reserve is released. This occurs because the after-tax addition to the reserve is never allowed as a deduction.

This can be illustrated by a simple example. Assume a company receives a $100 premium (net of expenses) and pays a $100 claim out of that premium one year later. The company earns $9 of investment income during the year. Under the Administration's proposal, the company may set aside the $100 as the initial QRA and must add the $6 of after-tax investment income to the QRA (assuming a 33% corporate tax rate); no deduction is allowed for the $6 added to the QRA; when the claim is paid, the entire $106 QRA must be included in income. Thus, the company has an additional $6 of taxable income after it pays the $100 claim. The company is taxed on $15 of income ($9 of investment income and the $6 additional amount released from the reserve). Under the QRA method, the company is taxed on 170 percent of its before-tax economic income (i.e., the $9 of investment income). Indeed, this shows that under the QRA method, income is created so that over time a property-casualty insurance company will include in taxable income an amount that is greater than its before-tax economic income.

Additionally, the QRA method taxes effectively tax-exempt income at the statutorily prescribed corporate tax rate. This can be illustrated easily by assuming that, in the example described above, the company invests entirely in tax exempts. Although the company will pay no tax as the investment income is earned, the QRA will be $109 when the $100 claim is paid. The company will be required to pay $3 in tax at that time. Normally, the tax treatment of tax-exempt investment income would be the same as the tax treatment of no investment income. This is not true under the QRA method; in the above example if a company has no investment income, no tax will be paid.

The Administration has failed to demonstrate that cash (or QRA) accounting is the best, or even an appropriate, method of accounting for a property-casualty insurance company.

The simple fact of the matter is this: in operation. QRA accounting is precisely the equivalent of cash accounting for the unpaid losses of property-casualty companies. Indeed, the Treasury Department concedes as much.[1] Thus, for this Committee to impose QRA accounting on property-casualty companies would be tantamount to denying them any deductions for their losses until actual payment of their claims.

It is ironic that QRA accounting is included in the Administration proposals, given the Administration's general advocacy of changing most current cash basis businesses to accrual tax accounting. With regard to other businesses, the Administration has said that cash accounting is improper because it frequently fails to reflect the economic results of a taxpayer's business over a taxable year. The cash method simply reflects actual cash receipts and disbursements, which need not be related to economic income. Obligations to pay and rights to receive payment are disregarded under the cash method, even though they directly bear on whether the business has generated an economic profit or loss. Because of its inadequacies, the cash method of accounting is not considered to be in accord with generally accepted accounting principles and, therefore, is not permissible for financial accounting purposes.[2]

Given the Administration's disenchantment with cash method accounting, and its preoccupation with matching revenues and expenses, it is difficult to understand—except, perhaps, in terms of a result-oriented preoccupation with raising revenue—how the Administration can seriously advocate cash-equivalent accounting for unpaid losses of property-casualty companies.

Quite apart from these programs, we see in the QRA proposal the additional detriment of administrative burdens. Even if it did not produce a distorted picture of a property-casualty company's economic income, we would oppose it for this reason alone. Imposition of a QRA approach would require a company to organize and report its loss data for tax purposes in a considerably different manner from the way it now assembles such data.

For example, under the Administration's proposal, a separate reserve account would need to be established for all claims under all policies in a particular line of business issued in a given taxable year. But property-casualty companies will bear the significant costs of reorganizing their information systems or, perhaps more accurately, creating systems parallel to the existing ones—solely for purposes of tax reporting.

The QRA would also encourage tax-planning strategies, and lead to audit disputes, regarding the characterization of expenses as investment-related so as to depress investment yield, and thus reduce the increment that must be made in the reserve accounts each year. This is hardly desirable.

The new additional administrative requirements that adoption of the QRA would entail would in turn necessitate the promulgation of detailed, complex regulations explaining those requirements. The process of crafting such regulations would be time-consuming and costly, and even so, companies would be left without needed guidance until the process was concluded. The resulting uncertainty would be unfair to property-casualty companies, would inevitably add to costs, and in the end would unwisely distract companies from productive pursuits.

Thus, whatever else may be said about the QRA, it surely is not tax simplification.[3] It is a theoretical economist's model that, even if correct (which it is not), suf-

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[1] See T. Neubig and C.E. Steuerle, "The Taxation of Income Flowing Through Financial Institutions: General Framework and Summary of Tax Issues" (United States Treasury Department, Office of Tax Analysis, OTA Paper No. 52, 1983), at 63-68. Neubig and Steuerle's paper demonstrates that identical financial results are obtained through the use of either cash accounting, or what they describe as a "qualified reserve method" of accounting, for future liabilities. The latter is QRA accounting.

[2] See page 213 of "The President's Tax Proposals" (May, 1985).

[3] In fact, the QRA is simultaneously too complex and oversimplified. Its oversimplified nature is demonstrated by the fact that it uses a single, company-wide investment earnings rate each

Continued

fers greatly in implementation. Existing law, by comparison, is much simpler both in theory and in operation, and because of this (and the flaws inherent in the tax revision proposals) we urge that existing law be maintained.

The primary justification used by the Administration for adopting the QRA method seems to be an inappropriate comparison between insurance and self-insurance (or, more accurately, noninsurance).

Under the reasons for change in the Administration's tax proposals, the current tax treatment of property-casualty insurance reserves is said to distort the choice between self-insurance and insurance.[4] In making this allegation it is unclear whether the Administration's proposal is comparing the self-insured with the policyholder of insurance, or whether the comparison is bing made between the self-insured and the property-casualty insurance company. In either case it compares apples and oranges.

A comparison between the self-insured and the policyholder of an insurance company is inappropriate because there is no economic equivalence between the two. The primary difference between the self-insured and the insured policyholder is that the self-insured has not transferred its risk of loss to someone else (putting its money at risk for someone else's losses), while the insured policyholder has.

Normally a taxpayer that chooses to self-insure will not set money aside and so has the use of the "premiums" it otherwise might have paid to a insurance company. At the end of any particular year, if a loss has not occurred, the self-insured continues to have use of the funds, together with added investment income. Historically, even if funds have been set aside, the self-insured has never been allowed a deduction for the "premium" because the self-insured retrains ownership of the funds and has use of such funds together with investment income thereon.

This is not true of the insured policyholder. The insured policyholder has a contractual relationship with the insurance company. The policyholder pays a premium to the insurance company and at the end of the year has nothing to show for its payment unless the insured has suffered a loss. If an insured policyholder suffers a loss, the insurance company has a contractual obligation to cover that loss. The insured policyholder is allowed a deduction for the premium paid because it has incurred an out-of-pocket premium expense. By the end of a year the insured policyholder has received and also has "consumed" everything it paid for-current insurance protection.

Likewise, the comparison between the self-insured and the property-casualty company is inappropriate. Just as there is no economic equivalence between a self-insured and insured policyholder, there is none between a self-insured and a property-casualty insurance company. Yet the Administration seems to be making such a comparison when it explains:

"P & C companies deduct currently the full amount of the future liability for many casualty losses that would not be deductible currently by a self-insurer. Because a current tax deduction is more valuable than a future deduction, individuals and businesses are encouraged to insure against risks with a P & C company in order to take advantage of this favorable tax treatment." [5]

The issue focused upon with respect to the self-insured is the proper timing for a deduction of a loss; with respect to the insurance company, the issue should be the proper measure of its profit (and therefore income). The insurance company is in the business of providing a service and bears all the financial risks of loss that are entailed with any business, and more. It does not accumulate funds as an escrow agent for the insured, as a bank might hold funds for a self-insured.

The statements quoted above assumed that the property-casualty insurance company is merely a holder of policyholder funds, rather than a separate entity in business to make a profit. The Administration's proposal ignores the fact that property-casualty insurance companies have a contractual obligation to provide a service (i.e., current insurance protection against economic loss). For the premium paid, the insured is entitled to that service alone, and is not entitled to any investment return on the premium payment.

A property-casualty insurance company has two sources of income—from any excess of premiums over losses and expenses, and from investment income. If a company uses some of its investment income and reduces the cost of the service to the

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year to determine the annual increment in each reserve account, whereas the rate of return on the investments attributable (although not segregated) to any one line of business may well differ from that attributable to another line. The precise theoretical matching envisioned by the proponents of the QRA is therefore questionable.

[4] See p. 267 of "The President's Tax Proposals" (May, 1985).

[5] See p. 267 of "The President's Tax Proposals" (May, 1985).

customer, because of market or regulatory pressures, there is no compelling tax policy rationale for taxing the company on that investment income in any case. The Administration's tax proposal for property-casualty incurance companies would tax that investment income (by disallowing an expense deduction) when it is used to pay claims. In this regard, property-casualty insurance companies would be treated unfairly as compared to other businesses that are not restricted in their use of before-tax income from all sources.

Apart from conceptual difficulties in understanding why an insurance company should be compared with a self-insured, there are numerous factual differences that lead to the conclusion that they are not similarly situated taxpayers for which a level playing field would make sense. As we have noted, insurance companies are subject to state regulation to assure solvency and to protect the interests of policyholders and claimants: (1) All insurance companies must file annual (statutory) statements with the various states in which they are licensed (in addition stock companies must prepare financial (GAAP) statements for shareholders; (2) States impose mandatory reserve requirements and regulatory restrictions on investments made by property-casualty insurers; (3) Insurance companies are subject to state taxes on premiums and are required to pay assessments for state guaranty funds; and (4) doing business in a particular state also may require participation in substandard risk pools, which are statutory mechanisms to provide insurance coverage to those who cannot buy the same in the open market.

All of these financial and regulatory constraints apply even if a company has a loss for the year. On the other hand, the taxpayer who elects to self-insure generally has no such regulatory constraints, nor the financial obligations to contribute to the insurance needs of the general public. In attempting to subject the property-casualty insurance company and the self-insured to equivalent tax treatment, the Administration's tax proposal indulges in a presumption of similar economic environments, which is contrary to the facts.

As an alternative to the QRA proposal, which would impose the equivalent of cash accounting on property-casualty loss reserves, the GAO has recommended that property-casualty companies be allowed to deduct their loss reserves, but would be required to discount such reserves to present value.

Specifically, the GAO would allow a property-casualty company, in the year a loss is incurred, to deduct the amount of the loss, discounted to present value at the company's before-tax rate of return on portfolio investments. Thereafter, the company would be allowed additional deductions for the annual increases in the reserve—again computed at the before-tax rate of return—until the claim actually was required to be paid.

In reality, any effort to discount expenses to present value would be beset by very serious problems of measurement and estimation. While we might attempt to rephrase the observations in our own words, we can hardly do better than to quote former Assistant Treasury Secretary Chapoton, who pointed out, in testimony in a hearing regarding time value of money on February 22, 1984, before this very Committee, that:

> While allowing a current deduction for the present discounted values of future expenses clearly is proper from the perspective of . . . financial statements, various practical considerations preclude implementing such a rule for income tax purposes.
>
> As an administrative matter, determining the present discounted values for all kinds of future expenses would introduce unmanageable uncertainty and undesirable complexity. Discount rates could not be determined individually for each business. Rather, certain economy-wide average discount rates would have to be employed. These discount rates would have to be applied to mere estimates of the amount of the expenses to be incurred at estimated dates in the future . . . [Such estimates] would be wrong in every case in which either the amount of the future expenses or the time for economic performance was estimated incorrectly, . . . [and there would have to be] a complex set of recomputation rules for recalculating overstated and understated deductions. . . .

Implementation of the GAO proposal would require exceedingly precise approximations of the times and amounts of a property-casualty insurer's loss payments. Underwriting estimations, particularly in long-tail lines, have proven so unpredictable (most notably as to amounts of loss payments) that they are viewed by industry analysts as a major contributor to insurance company underreserving. Yet under the mechanics of the GAO proposal, a company would be significantly penalized for such underestimation. While GAO's suggestion might make sense for transactions that do not involve measurable risk (such as simple deposits held at interest with stated maturities), its application to risk-pooling activities is off the mark.

The inherent uncertainty in applying any method of discounting, and its potential for distortion of real economic earnings, has been recognized by the accounting profession in its standards for financial reporting by property-casualty insurance companies. The Financial Accounting Standards Board has concluded that ". . . losses should be recognized . . . as incurred . . ." (FASB, Statement of Position 78-6). The Board further cautioned that companies that choose to discount loss reserves for financial statements in contravention of full loss recognition should disclose this fact to shareholders and investors.

Given the problems that underwriters, corporate actuaries, investment advisors and independent financial auditors see in the application of discounting for property and casualty loss reserves—to wit: mismatching items of income and expense, potential distortion of economic income (or loss), accounting and tax complexity, and uncertainty in estimations—we believe that any discounting proposal will prove inequitable and unworkable.

To respond to the additional burden placed on surplus by the Administration's tax proposal, property-casualty insurers would be forced to increase their premiums dramatically. One of the most respected insurance analysts, Robert A. Bailey, Vice President of the Property/Casualty Division of A.M. Best Company, the independent organization that rates insurance company solvency, has predicted that if the QRA were enacted into law, the industry would have to increase premiums an average of 11 percent in order to make up for the lost income, as well as the additional commissions, State premium taxes and other overhead expenses. In certain long-tail lines of business the industry would be forced to increase premiums from 15 percent to 32 percent, depending on the line of business. Mr. Bailey has estimated that premium increases of 32 percent would be necessary for medical malpractice, 24 percent for general liability, and 15 percent for workers' compensation and reinsurance.[6]

The ability of a casualty insurer to write new business ("capacity") or assume higher limits of liability is a function of its available surplus. A general yardstick used by insurance regulators in testing for potential insolvency of a company is that a company's net written premium's should be no greater than three times its statutory surplus.

Property-casualty insurers recently have posted record operating (not merely underwriting) losses, are having to actually strengthen their undiscounted loss reserves, and are scrambling to add to surplus. These events have created a significant shortage of the property-casualty industry's ability (or "capacity") to write all the coverage for which there is a demand.

The current depletion in surplus is a direct result of the successively larger underwriting losses experienced by the industry each year for the past six years. In 1984, the industry had over $21.3 billion in underwriting losses and $3.8 billion in before-tax net operating losses. (If five major writers of personal lines of insurance—automobile and homeowners—are eliminated, because they made a profit, losses posted by "loss companies" were closer to $5 billion.) A.M. Best Company has estimated that the indsutry will incur underwriting losses of $23 billion in 1985. As a consequence of these losses, the industry's surplus has declined nearly $2 billion in 1984.

In a study by the Insurance Services Office entitled "The Coming Capacity Shortage", the industry's rating service predicts that—due to the recent losses—available property-casualty insurance may fall short of demand by some $62 billion over the next three years. This prediction does not take into account the impact of the QRA or GAO proposals on the industry's surplus. The capacity shortage facing the industry is directly related to the reduction in surplus.

Unfortunately, however, at a time when the industry's ability to meet the needs of the insurance marketplace is precarious at best, the QRA and GAO proposals would reduce surplus even more, thereby further exacerbating the availability problem. By the Administration's own estimates, the industry's tax burden, when QRA is fully phased in, would be increased by approximately $3 billion per year. Altering taxation of the property-casualty industry by this magnitude will worsen an already serious shortage of capacity and result in significant increases in the price of coverage.

Shrinkage in capacity, with its accompanying decrease in availability of certain types of insurance, will have obviously adverse consequences for potential insurance customers. The failure to find available insurance will impact adversely the great majority of those businesses that simply cannot afford to retain risk.

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[6] These predictions for premium increases are based on Treasury's initial recommendation for QRA and a 46% corporate rate. The use of the 46% rate is consistent with Treasury's standard estimating procedures. Treasury's initial proposal is substantively unchanged under the Administration's final tax proposal for QRA.

Normally, increases in the price of coverage actually further exacerbate the capacity shortage because of the required relationship of surplus to premiums. Thus, the additional tax imposed on the industry will trigger a chain of price increases aimed both at restoring the surplus depleted by the taxes and increasing the surplus to support the premium increases themselves. Looked at another way, the industry will be squeezed both from the top-down (the premiums-to-surplus ratio), as it suffers surplus diminution from significant tax increases that would be imposed at a time of record operating losses, and from the bottom-up (premium inflation), as premiums are adjusted upward to stem debilitating underwriting losses and preserve surplus. Proposals to substantially increase industry taxes, then, are a Catch-22 that will stymie the ability of property-casualty insurers to meet marketplace demand.

Changes in the taxation of property-casualty insurance companies also will impact adversely on the U.S. insurance industry's participation in the world market and, in fact, favor foreign insurers of U.S. risks. A substantial portion of U.S. risks already are insured by foreign insurance companies (from 1982 to 1983 alone, the net premium outflow from U.S. insurance companies to foreign reinsurers increased from $1.0 billion to $2.3 billion). Any increase in premiums charged by domestic property-casualty insurance companies can only result in a higher market share going to foreign competition.

Unlike other U.S. industries, the insurance industry is very portable. It does not require the movement of physical plant, nor does it rely on natural resources within the United States. The placement of insurance depends on capacity of the established market places and requires only a knowledge of those markets. Generally, there is no financial constraint on paying premiums outside the United States, since recently negotiated tax treaties generally eliminate the excise tax on premiums paid to foreign insurers. Marketed through independent agents or brokers, U.S. risks can be placed as easily with a foreign insurer as with a domestic company.

The ease of placing insurance abroad was illustrated by a report in The Wall Street Journal (Tuesday, July 2, 1985; p. 10) that fifteen industrial companies have agreed to organize an insurance company for their own liability coverage. The company will be located in the Cayman Islands. The article noted that the organization of the new company is a further indication of how the market for business liability insurance has tightened during the past year. The amount of money being contributed to start the company (a total of $140 million), gives only a hint of the potential premium outflow for this foreign company alone.

At present there is some flow of premium dollars from multinational corporations into the U.S. insurance markets. If U.S. insurance costs increase substantially, in response to a pass-through of increased tax costs, those foreign dollars do not have to come to the United States. Likewise, the potential for moving money for U.S. risks to foreign insurance markets and investment is virtually unlimited. Under the increased tax burden proposed by the Administration, the problems of foreign competition for U.S. insurance companies (and indirectly the U.S. balance of payments) only will be compounded.

Foreign-based companies will have the attractive choice of undercutting the price of U.S. insurers or matching prices and increasing profits. Other repercussions could be the capture of the bulk of the reinsurance market, by foreign reinsurers, and the relegation of U.S. insurers to mere primary insurer status. Finally, this could enhance the status of U.S. insurers as targets for takeover by foreign competitors.

The property-casualty industry has repeatedly underestimated its longer-term losses, a difficulty exacerbated by economic and "social" (i.e., jury award) inflation. A study done by the Insurance Service Office last year, analyzing loss reserves and rates of return for property-casualty insurers, concluded that property-casualty insurers were underreserved by an amount in excess of 10 percent of their reported reserves. (See ISO, Analyses of Loss Reserves and Rates of Return, 1984.) Focusing in particular on the general liability insurance line, this study pointed out that insurers had a loss reserve deficiency in excess of 20 percent. It thus appears that property-casualty insurers (especially in respect of the long-tail lines) have already routinely understated expenses and overstated income in their financial reporting. And since the same amounts of loss reserves are used to determine Federal taxable income, the same would be true for tax reporting.

In view of this, one wonders why the Administration and the GAO so strongly perceive that property-casualty companies' loss reserves are conservative, over-sufficient amounts that result in the understatement of economic income. To the contrary, when the facts are known, it becomes apparent that the QRA and discounting proposals would work from already insuffiecent loss reserve figures to produce even more dramatic overstatements of income. They would, in short, tax companies on much more than their economic income.

For all of these reasons, we believe the QRA and GAO proposals are ill-conceived and must be rejected. At this juncture, however, we think it appropriate to step back and ask why we find ourselves responding to tax revision proposals such as these. At base, we believe this whole exercise is motivated by a perception on the part of the Administration and the GAO that our industry is undertaxed. The assertion is that the so-called "effective" rate of tax borne by the members of our industry is low.

If the property-casualty insurance industry pays tax at a low effective rate, it is because of investments in tax-exempts. Our industry is not a major user of accelerated deductions and credits, but it is a major holder of tax-exempt bonds. Consequently, its effective tax rate on economic income (which includes the tax exempt income) is lower than the statutory rate.

However, in addition to the direct tax paid, there is an indirect tax paid with respect to interest received from tax-exempt state and municipal bonds. On state and municipal bonds, the interest received is lower than on taxable bonds. In economic terms, this interest reduction may be viewed as an indirect tax that is "paid" directly to the states and municipalities rather than collected by the federal government and distributed to the states as an explicit subsidy.

Congress has accorded all taxpayers, including property-casulty companies, the choice of investing in tax-exempts as well as taxable instruments. When a taxpayer chooses to purchase a tax-exempt instrument, that taxpayer bears the burden of the indirect tax implicit in the instrument's lower yield. Such a choice entails, of course, a lower effective tax rate on that taxpayer if one excludes the impact of the implicit tax, though it results in an appropriate overall tax burden when direct and indirect levies are considered together and expressed as a ratio of "economic income". Many companies in our industry have chosen this investment route for much of their portfolios.

In considering the relative merits of current law and proposals to alter the taxation of property-casualty insurers, Congressional tax policymakers should be mindful of several general principles that we believe promte sound tax policy and fairness.

First, and foremost, we believe that the Committee should only consider proposals for taxing property-casualty insurers that generate tax liability when there is economic income. While the definition of what constitutes economic income may be open to reasonable debate, there should be no serious dispute with the notion that where, by anyone's standards, there has been a real economic loss, there should be no federal tax liability assessed.

Second, we urge the Committee to respect the notion that property-casualty insurance companies are not unlike any other corporate taxpayer with complex accounting and income measurement problems. The goal of the Federal corporate income tax is to measure income and tax it at the corporate level in an equitable manner. Property-casualty insurance companies should be taxed according to rules that, to the extent possible, reflect the general rules of corporate income taxation. There is nothing inherent in the organization of or transactions by property-casualty insurance companies that suggests abandonment of the general corporate income tax rules.

Third, we believe that the Committee should assess any property-casualty insurance company tax proposal on the basis of competitive neutrality within the industry. The intramural playing field should be level. Every effort should be made to ensure that revisions in the income taxation of property-casualty insurers do not unduly advantage or disadvantage any company or group of companies because of their lines of business.

Finally, it is the position of the member companies of the American Insurance Association that any proposal suggesting changes in property-casualty insurance taxation be consistent with the Administration's own stated goal of simplicity. Overly complex and theoretical constructions lend themselves to unforeseen side-effects, opportunities for avoidance, pitfalls for the unwary and uneven application of tax burdens across the industry. Careful consideration should be given to any serious deviations from the historic system of Annual Statement accounting. There is an appropriate balance between simplicity and equity, and we urge the Committee to give due deference to the competing considerations that are embodied in the current system of property-casualty insurance company tax accounting.

Recently, certain Congressional tax policymakers have raised the question of whether a federal premium tax should be considered as a possible alternative system for taxing property-casualty insurance companies. Its initial appeal may be that a premium tax appears to be simple and would ensure the collection of a certain minimum amount of revenue from the property-casualty insurance industry. On closer examination, we think that the members will conclude that a federal premium tax would be inequitable and would violate every one of the sound tax policy principles discussed above.

First, just like a sales tax, a federal premium tax would be regressive. It would not take into account the taxable income or true economic income of the company. As a gross receipts tax, it would be imposed whether or not a company had an economic gain or loss during the year.

Second, a premium tax in lieu of an income tax would single out the property-casualty insurance industry for a unique tax treatment, unshared by an other corporate taxpayer. It would isolate that industry from the general corporate business community. The property-casualty insurance would be prohibited from using the general corporate tax relief provisions enjoyed by other taxpayers (e.g., depreciation, investment tax credit, NOLS, foregin tax credit, etc.). If the federal premium tax is adopted in addition to the application of the general corporate income tax provisions, it would be a unique and, thus, unfair additional tax burden for the industry to bear.

Third, as a practical matter, a federal premium tax would not be competitively neutral between different lines of business within the property-casualty insurance industry. A premium tax on short-tail, personal lines of business can be readily passed on to the policyholder (which ultimately may raise the question of whether the tax is being paid by the company or the policyholder). On the other hand, the direct impact of a premium tax on long-tail commercial insurance or malpractice insurance will be more adverse because those are the very lines of business currently undergoing rate increases due to unpredictable increased costs of emerging liabilities and court awards. Thus, that portion of the business which is undergoing capacity shortages and trends toward self-insurance would suffer further under a premium tax.

Fourth, a closer examination of a premium tax structure will reveal significant underlying complexities. Complex issues involving the definition of "premium," the treatment of policyholder dividends, the treatment of service charges or finance charges, credits for reinsurance premiums paid, and similar issues, have all been the subject of continuing controversy at the State level. What would become of existing income tax attributes? Could they, or would they, be integrated into a premium tax? Even the use of a premium tax as a temporary measure would cause confusion and, later, complexity because of the interruption in the natural continuation of the income tax system applicable to the property-casualty insurance industry.

Before we conclude our remarks, we would also note that the Administration proposes in the same context to reverse what Congress did just 3 years ago in legislating the tax treatment of "strucutured settlement" annuities. Just as we believe it unsound to place insurers on cash method accounting with respect to their accrued losses, we consider it unsound to extend such treatment to structured settlements generally.

We acknowledge, of course, that there is an interest component to a structured settlement annuity, and that the tax treatment this arrangement now receives is favorable. Indeed, structured settlements have gained their popularity precisely because, for a host of reasons outweighing this favorable tax treatment, they are beneficial to all the parties involved. Claimants who agree to a structured settlement receive more in total dollars than they would from a lump sum settlement, while defendants are able to save claim dollars. without the favorable tax treatment accorded structured settlements as under current law, a major incentive to both parties to agree to such arrangements would be lost.

We believe that the tax incentive currently provided to injured parties to take structured settlements is affirmatively good and should be maintained. These settlements are a socially desirable means of guaranteeing the future financial security of unfortunate accident victims, frequently badly injured and typically from lower economic levels. We are not dealing here with a voluntary investment option that can be availed of by shrewd investors as a tax shelter.

Implementation of the Administration's proposal would dramatically reduce the use of structured settlements. In so doing, it would penalize a very needy segment of the population, would further burden the already intolerable court system backlog as more cases go to trial, and would ultimately increase the costs of public assistance programs. It would also arbitrarily reverse the clearly stated intent of Congress, from as recently as 1982, that tax favorable treatment should be provided. We therefore believe that the Administration's proposal in this regard should not be adopted.

VI. CONCLUSION

AIA suppports the goal of reforming and simplifying the Federal tax laws. Our members would endorse a proposal that truly promotes economic growth and encourages balanced competition between both domestic and foreign insurers.

However, we think that the Administration's proposal to use the QRA method of accounting would distort the income of the property-casualty insurance company. As a result, the proposal will necessitate price increases, will threaten to strain existing capacity shortages even further will encourage unregulated risk retention, and will present serious international trade questions. The GAO proposal would have similar adverse consequences. Before adopting any legislative changes for taxing the property-casualty insurance industry, Congress should keep in mind the four general principles of sound tax policy we discussed earlier.

This statement has focused on the QRA and GAO proposals and the impact that this adoption would have on the property-casualty insurance industry. Although we have not addressed the Administration's other proposals affecting members of our insurance industry, we see no need for any of the changes recommended. We do not believe that the present tax system fosters any competitive imbalance between stock and mutual companies. Furthermore, we believe the smaller companies which benefit from certain special rules serve an important function in providing for the insurance needs of this country. Accordingly, we generally endorse the comments made by the other property-casualty trade associations on the proposals which were not specifically addressed in this statement.

STATEMENT OF ANDRE MAISONPIERRE, PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA, WASHINGTON, DC

Senator LONG. Mr. Maisonpierre. Is that how you pronounce your name, sir?

Mr. MAISONPIERRE. You are doing an excellent job, Mr. Chairman. [Laughter.]

Mr. MAISONPIERRE. It's obvious that you know how to speak French.

Thank you, Mr. Chairman. I'm the president of the Reinsurance Association, which is a trade association representing the U.S. professional reinsurers. Mr. Chairman, we oppose the General Accounting as well as the administration's tax proposals dealing with property and casualty insurance. None of them are warranted.

We would like to limit our comments today, however, to the unique impact which QRA and to some extent discounting will have on reinsurers. And how in turn this will adversely affect the U.S. balance of payment.

Insurance and particularly reinsurance is a highly fungible international commodity. It is irrational to think that U.S. insurers and reinsurers would be immune from the comparative impact of tax-induced increases in operating costs, if these increased costs did not likewise apply to the alien competition.

The proposals before you violate a major canon of fiscal policy. They fail to structure a tax system which is broadly based and uniform in application across competing taxpayers.

Treasury preaches that consumer choice between competitors should not be influenced by tax law, yet its plan is anything but neutral. And it will aggravate America's balance-of-payment problems.

Treasury concedes that the tax burden to be generated on the industry will, in fact, be heavy. It anticipates that insurers will offset this cost by substantial increases in premiums. Unfortunately, U.S. reinsurers will find it difficult to adjust their charges since competition from alien reinsurers not subject to the U.S. Tax Code will act as a deterrent to adequate pricing.

It is ironic that this administration is proposing legislation which would place the U.S. domestic insurance and reinsurance industry at a disadvantage in competing for U.S. business in the United States when, as noted in a recent report issued by the Office of the U.S. Trade Representative, there are at least 35 countries, including the European Economic Market, which are restricting U.S. insurers' operations within their borders.

The proposals, if enacted into law, would have certain natural consequences. For instance, alien reinsurers exempt from the effect of the tax will substantially increase their penetration of the U.S. insurance market to the detriment of the U.S. reinsurance industry. The large alien reinsurers, with established U.S. subsidiaries or branches, which today are, indeed, taxed as U.S. insurers, will find it economically attractive to shift their U.S.-generated business directly to the alien parents, thereby avoiding the tax burden. The surplus funds supporting the business, which will be shifted abroad, will likewise be shifted offshore.

Now the result of these changes in economic behavior will increase the flow of premium dollars to foreign insurance companies unaffected by the tax burden; will decrease the flow of foreign-generated premium to the United States; and will require the transfer of large amounts of insurance surplus funds overseas in part to support the increased direct U.S. activities of alien reinsurers.

We have estimated, for instance, that the administration's plan will result in a shift of approximately $7 billion in premiums to overseas companies, and an additional $2.8 billion in surplus fund to support the $7 billion of transferred premiums.

It should be noted that this $9.8 billion increase in our balance-of-payment deficit is almost two 2½ times greater than the entire-balance-of-payment deficit for 1983.

Mr. Chairman, we urge you and the committee to reject the administration's and the General Accounting's proposals. And we also urge you to support the proposals submitted to you by the industry. The enactment of the GAO and the administration's proposal will seriously hinder the growth of the U.S. professional reinsurers and their ability to meet current expanding needs of the U.S. insurance industry. Further such programs will, as we have noted, seriously adversely affect our foreign trade deficit.

Thank you very much, sir.

Senator Long. Thank you.

[The prepared written statement of Mr. Maisonpierre follows:]

STATEMENT
OF THE
REINSURANCE ASSOCIATION OF AMERICA

My name is Andre Maisonpierre. I am the President of the Reinsurance Association of America, a trade association of professional reinsurers. Our member companies are professional reinsurers principally engaged in the business of assuming property and casualty (p/c) reinsurance and are either domestic U.S. companies or U.S. branches of foreign reinsurers entered through and licensed by a state. All the companies are subject to the regulatory jurisdictions of the various states in which they are domiciled or licensed. Reinsurance is a secondary risk distribution mechanism, whereby insurers themselves insure some of the exposures which they assume with other insurers, called reinsurers. In other words, insurers will pay premiums to reinsurers and will, in turn, be reimbursed in part, for loss payments which they make to policyholders.

PREFACE

Property and casualty reinsurers are regulated and taxed as property and casualty insurers. As such, they are affected by those provisions in the President's tax proposal affecting p/c insurance.

Mr. Chairman, the Association opposes all sections of the proposal which deal with property and casualty insurance. Although a number of the suggested changes do not directly impact on our members, we believe that none of them are warranted. However, since the revision in the treatment of loss and unearned premium reserves are the principal proposals which specifically affect p/c reinsurers, we will limit our comments to those proposals.

Enactment of the proposal to require companies to establish Qualified Reserve Accounts (QRAs) will seriously hinder the growth of U.S. professional reinsurers and their ability to meet the current and expanding needs of the U.S. insurance industry. Treasury concedes that the tax burden to be generated by the proposal on the p/c industry will be heavy. It anticipates that the companies will offset this cost by substantial increases in premium.

Unfortunately, U.S. reinsurers will find it difficult to adjust their charges since competition from alien reinsurers, not subject to the U.S. tax code, will act as a deterrent to adequate pricing.

If QRA is enacted into law, certain natural consequences are bound to evolve:

- Alien reinsurers, exempt from the effects of the tax will substantially increase their penetration of the U.S. insurance market, to the detriment of the U.S. reinsurance industry.

- The U.S. reinsurance industry will, to the extent possible, shift to foreign subsidiaries their foreign generated premium.

- Conversely, the large alien reinsurers with established U.S. subsidiaries or branches will find it economically attractive to shift their U.S. generated business directly to the alien parent; thus, avoiding the QRA burden.

- The surplus funds supporting the business which will be shifted abroad will likewise be shifted offshore.

These behavioral changes in world reinsurance marketing will have a profound impact on the U.S. Balance of Payments. We estimate that the net effect on the Non-Merchandise Insurance

Balance to be an additional deficit of $7 billion and an additional deficit of $2.8 billion charged against the Balance of Payments as capital funds are sent offshore to support the increased foreign reinsurance activities. Thus, a total deficit increase in the Balance of Payments of $9.8 billion will result from enactment of QRA, an amount almost 2.5 times larger than the entire Balance of Payments deficit for 1983 and almost 10% of the 1984 Current Account Balance deficit.

QRA, of course, affects insurers as well as reinsurers. However, its impact on reinsurers can be more easily ascertained since reinsurance is such an extremely fungible international commodity and U.S. reinsurers must compete, toe to toe, in a very active international market. Note that only three U.S. companies are among the 10 largest world reinsurers.* This does not imply, however, that U.S. insurers will have an easy task to raise their prices sufficiently to offset the impact of QRA on their business. There will probably be strong resistance by state insurance regulators to burden consumers with the quantum cost increases which will be needed to offset the tax and many commercial risks will carefully look at substitute insurance outlets: the offshore market or self insurance as a way to escape the effect of the tax.

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* The Global Picture - ReActions. June 1985, p. 62.

We will not waste the committee's time in detailing the operation of QRA on companies, since this would be duplicative of other statements presented to the committee. We do, however, want to emphasize the unfairness of QRA. It does not close loopholes in p/c insurance industry taxation, but effectively increases the industry tax rate by subjecting its investment income to double taxation. Further:

- It taxes "tax exempt" investment income.
- It levies a tax on companies even though an economic loss may have been sustained.
- It places the p/c insurance industry on a cash basis.
- It seriously undermines the reliability of the surplus account of a company, thus making it impossible to evaluate the financial stability of the company.
- It would create an administrative nightmare.

Our statement will concentrate on the unique impact of QRA on reinsurers and how this, in turn, will affect the U.S. balance of payment.

QRA AND BALANCE OF PAYMENTS

Introduction

Property and casualty (p/c) insurance is the lubrication which permits the economy to operate.* It allows corporations and even governments to assume risks which are inherent to the enterprise and to disassociate themselves from those risks about which they know little or cannot control.

P/C insurance is, however, predicated on the ability of the insurers to make good on their policies. Only by so doing can they perform their unique and essential role in society.

Governments have repeatedly recognized the desirable role played by p/c insurers by mandating the purchase of insurance -- i.e., automobile or workers compensation insurance. Congress is no exception. Note the enactment by Congress of financial responsibility laws requiring insurance, or the equivalent, for trucks, waste users and disposers, nuclear power operators, etc. With respect to the need to fund currently for future obligations, one must point to the basic objective of ERISA as being a forcing mechanism to ensure a more realistic funding of retirement plans.

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* See Appendix C for a discussion of the Economic Role of Property-Casualty Insurance, and Appendix D on the Function of Reserves in Property-Casualty Insurance.

In order for insurers to fulfill their social mission, they must provide today for the payment of losses which their clients have incurred even though the obligation to pay for those losses might be delayed to some future date. Governments worldwide have recognized that the method of taxation of insurers has a direct impact on solvency. Any attempt to tax the provisions made by p/c insurers for the payment of incurred losses is regarded as self-defeating. It undermines the ability of insurers to deliver on their promises to pay and could ultimately require government to assume the future obligations which were prevented from being adequately funded. Although our international community is composed of widely different societies -- from a varying degree of free enterprise market economies, to tightly controlled social and economic planning -- the collective wisdom of governments around the world has been to recognize the unique responsibility of p/c insurers and to encourage an adequate level of funding for losses incurred. Also recognized is the basic principle that the metric of taxable income must be related to the regulatory metric of solvency income if p/c insurers are to survive.

Many industrial countries have been considerably more supportive of this basic concept than the United States. For instance, a number of countries allow for the sheltering of investment income generated from loss reserves. The Internal Revenue Code already requires that such investment income be taxed in the year earned. Many countries allow p/c insurers to set aside catastrophe reserves for losses which have not been incurred but may reasonably be expected, such as earthquake related losses. Indeed, the inability to reserve for such contingencies severely limits the insurance capacity for certain risks in the U.S., and also exposes the U.S. p/c insurance industry to potential economic disasters if a major catastrophe were to occur.*

World governments have imposed strict discipline on p/c insurers so as to regulate the reliability of their promise to pay. These disciplines have transcended the peculiarities of nations and have been reinforced by their taxation systems. Current U.S. tax provisions give some recognition to the uniqueness of p/c insurance. This Administration, however, proposes to remove itself from this common understanding. In doing so, it endangers the solidity of the U.S. p/c insurance business, threatens the dependence of the economy on the reliability of the p/c insurance industry to respond to losses and provides a major competitive advantage to foreign insurers which will reap a major benefit from this tax proposal. The fact is that the Administration proposal fails to address and has overlooked the grave economic consequences of its plan as it will affect the ability of the domestic p/c industry to compete internationally and the resulting impact on our Balance of Payments.

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* The Reinsurance Association is urging consideration of federal legislation to relieve this situation. The proposal is not tax related, since we believe there are more effective ways to handle contingencies of this nature than through contingency reserves.

Nevertheless, the effect of the Administration's tax package on our international balance of payment is of obvious concern to the members of this committee, the Federal Reserve Board and the financial markets. It makes no sense to us, and it obviously makes no sense to many members of this committee, that one should create the illusion of tackling our fiscal deficit by aggravating our international balance of payments shortfall.

Repeated questions have been addressed to Administration witnesses requesting assurances that the plan does not and will not adversely affect an already intolerable balance of payments situation. Based on extensive analysis we cannot accept the assurances which you have received. To the contrary, this tax plan will dramatically worsen the existing unfavorable insurance trade balance. Furthermore, as a result of the shift to foreign insurance markets, the insurance related revenue estimates will fall short of their projected goals.

We are well aware that GAO has minimized in its report the industry's inability to compete with foreign insurers in case of a major change in the insurance tax system. GAO states that:

- Foreign competition is a relatively small part of the U.S. insurance market.

- Most foreign competitors have U.S. subsidiaries or branches which are subject to U.S. taxes.

- Any improvement in the competitiveness of foreign companies will only benefit those foreign companies that have no U.S. operation and can write reinsurance on U.S. risks.

We disagree with the GAO's observations. Furthermore, we are disappointed at the superficiality of the discussion, considering the pains which GAO has taken to rebut many of the other comments of the industry to its report. We are entitled to a more thoughtful explanation.

What are the facts? What are the likely effects of the treatment of insurance taxation on international trade?

The International Insurance Market -- A Two-Way Street

First, let us make it clear that, contrary to what GAO says, there is today a very active international insurance market, involving billions of dollars of insurance and reinsurance purchased by U.S. policyholders, insurers and reinsurers from foreign companies, as well as an extensive although lesser amount of insurance sold by U.S. reinsurers to foreign insurers and reinsurers.

This international insurance trade which affects U.S. insurers, reinsurers and policyholders amounts to several billions of dollars. It is a growing trade. It is also a trade which has traditionally added to our foreign deficit.* That the exact amount of the trade cannot be quantified with precision due to the lack of any systematic data collection is immaterial. What is important is that:

- In 1983, about $3.2 billion in premium -- approximately 29 percent of present U.S. reinsurance market -- was ceded to alien companies;
- Direct insurance premiums paid by U.S. policyholders to alien companies for U.S. risks in 1983 are estimated to be substantially in excess of $800 million;
- As far back as the Department of Commerce published data goes, the U.S. has sustained a net loss in its reinsurance trade balance.

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* For a summary of available data on U.S. international insurance trade, see Appendix A.

The International Insurance Market -- A Combination of Multiple Components

What kinds of transactions comprise this vast international market.

First, there is the reinsurance bought by U.S. insurance and reinsurance companies from insurers resident abroad. We believe that this can most readily be measured by data collected by the U.S. Department of Commerce, Bureau of Economic Analysis. For 1984, this amounted to ______ billion.* Compared to the 1983 figure of $3.2 billion, it also represents a sizable increase for one year!

Second, is the direct insurance purchased by U.S. companies -- manufacturers, utilities, etc., from foreign insurers and captives. It has been estimated, for instance, that worldwide the number of captives has grown from 165 in 1970 to 1,500 in 1982. In 1983, there were 1,203 registered insurers in Bermuda alone, generating a gross premium of approximately $6 billion, much of which emanated from the U.S. In an August 1984 report, Conning & Company, a firm which specializes in the analysis of insurance stocks as well as insurance operation and management, had the following to say with respect to the captive movement:

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* Note: The figure will be inserted as soon as we receive it from U.S. Dept. of Commerce. It is due for release momentarily.

> "It has been estimated that over 200 firms in the Fortune 500 now have captives in place, and there are close to 1,500 captives throughout the world. As the single parent captive market has become saturated, more group captives are being established, possibly confronting the U.S. insurance industry with a new challenge regarding its ability to amass homogeneous books of preferred commercial business at competitive rates.
>
> "The pursuit of 'non-parent' or open market reinsurance by offshore captives and reinsurers has been a secondary source of growth for them. This activity has also threatened the market shares of traditional reinsurance companies."

Based on data collected by the states on direct insurance on risks within the states placed with unlicensed insurers, at least $800 million of direct premium was placed with alien, unlicensed insurers in 1983. This is a conservative estimate and many believe the volume of direct business placed offshore to be far greater.*

Third, is the reinsurance sold (assumed) by U.S. insurance and reinsurance companies to foreign insurers and reinsurers. The published data from the U.S. Department of

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* Conning and Co. estimates the value of captive insurance premium to be on the order of $6 billion a year, most of which is placed with offshore companies.

Commerce reports these assumed reinsurance premiums as slightly in excess of $1 billion for 1983.

Fourth, are the payments of losses arising from the insurance and reinsurance assumed by U.S. and foreign companies. Again, referring to the Department of Commerce data for 1983, losses recovered from abroad on ceded reinsurance amounted to slightly in excess of $1.5 billion and the losses paid abroad on assumed reinsurance were approximately $800 million.

We have already noted that the Department of Commerce has reported a net reinsurance trade deficit since 1970. The increase in the reinsurance trade deficit is due to a more rapid growth in reinsurance placed abroad than in reinsurance imported. The U.S. Department of Commerce attributes the rapid growth in reinsurance placed abroad to "the increasing number of risks transferred by U.S. companies to their foreign affiliates ... where the tax treatment and regulation of insurance companies was more favorable than in the United States." For 1983, the net deficit amounted to approximately $.5 billion. The International Monetary Fund (IMF) estimates the deficit on direct insurance to be $43 million in 1983. However, the direct insurance deficit is in fact likely to be in excess of this amount since the IMF estimate is based on old data which does not reflect the current structure of the U.S. industry and volume of direct insurance purchased from alien insurers.

The persistent net trade deficit in insurance has a significant impact on the total U.S. Balance of Payments deficit. In 1983, the net insurance deficit was 13.5 percent of the Balance of Payments deficit and this insurance deficit accounted for over half the Balance of Payments deficits as recently as 1981.

In spite of the lack of precision in trade data, we are convinced that these numbers are ample to rebut GAO's assertion that the international insurance trade is of no great relevance. There exists today a very active international market -- a growing market which is a direct result of a growing sophistication of insurance buyers who are constantly on the lookout for better coverages, at low prices, as well as active marketing activities by international insurance brokers who are incessantly seeking new distribution outlets. Furthermore, the Chairman of Lloyd's of London announced at the June 1985 meeting of the National Association of Insurance Commissioners that Lloyd's is increasing its capacity by 15 percent and appointing brokers in the U.S. as a new method of generating business. Thus, Lloyd's will be prepared to take advantage of any changes in the U.S. tax laws that give them a competitive edge.

Insurance -- A Highly Fungible International Commodity

Although the Treasury analysis invites one to make such an assumption, it is irrational to think that today's international insurance market is static and that U.S. insurers would be immune from the competitive impact of tax-induced increases in operating costs. Insurance is a highly fungible international commodity. Specifically, if a limited number of insurers (the American domestic market) must, as the Treasury predicts, raise their prices because they are burdened by a significant tax increase which does not reach their competitors (alien companies), it stands to reason that more U.S. companies, insurers and reinsurers will seek to buy coverage with the foreign competition and fewer foreign companies will seek coverage in the U.S. The result will lead to greater outflow of dollars and a diminution of inflow of funds to the U.S.

The premium outflow will be somewhat offset by reinsured loss recoveries, although anticipated premium outflow due to QRA will insure that the gap will continue to widen. Additionally, there is a time lag between the premium payment and the payment of losses arising from such premium. This lag results in substantial delay in the "return" flow of part of the American insurance premium from abroad in the form of claims payments paid to the U.S. companies. The lines of insurance primarily affected by the Administration's proposal are the "long tail lines," for which losses continue to be paid many years after the premiums are collected. Thus, the delay in repayment will extend for many years and the current balance of trade will be that much the worse for it.*

To summarize, the insurance market is quite sensitive to international trade. This is not surprising, in light of the multinational expansion of U.S. businesses and the ease which allows purely U.S. risks to insure directly with foreign companies. This international insurance trade takes a variety of forms:

- Reinsurance may be assumed and ceded (bought and sold) by U.S. insurers and reinsurers from abroad;
- Direct insurance on U.S. risks may be purchased by U.S. companies through captives or non-related alien companies;
- U.S. companies may purchase direct insurance in the U.S. for their overseas operations. (No one knows the extent of this market); and

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* G.M. Dickinson, Etudes et Dossiers No. 16. International Insurance Transactions and the Balance of Payments The City University Business School.

- Foreign policyholders may purchase direct insurance coverage with U.S. insurers in the U.S., for business activities transacted both in the U.S. and abroad. (Again, no data are available on this form of insurance trade.)

Impact of QRA on Insurance Buying Decisions

How will these transactions be affected by a substantial tax increase on U.S. insurers?

Both U.S. and foreign policyholders buy insurance and reinsurance from a wide variety of U.S. and foreign insurance companies. Their purchasing decisions are extremely price sensitive and they and their brokers regularly seek out the low price provider of insurance services. As Treasury recognizes, the companies subject to substantial tax increases will need to increase their prices. In fact, Treasury tells us, this is an important objective of its plan.

But the price increases will be uneven. They will not be uniform across all lines of insurances and they will certainly not be uniform across all competitors since many will be in positions to escape the tax increase altogether. Yet the Treasury seems to have failed to recognize that the international nature of insurance would allow many insurance buyers to escape the price increase.

In fact, the Administration plan violates a major canon of fiscal policy. It fails to structure a tax system which is broadly based and uniform in application across competing taxpayers. As the Treasury preaches, consumer choice as between competitors should not be influenced by tax law. Yet its plan is anything but neutral and will aggravate America's balance of payments.

Obviously, both U.S. and foreign policyholders will seek to escape the increased premiums which U.S. insurers and reinsurers will need to charge to offset the tax increases. Foreign insurers and reinsurers will be in position to offer less costly insurance. The present excise tax levied on insurance placed offshore will not be an effective deterrent since it is exempted by treaties which the U.S. has entered into with many countries. Additionally, the large alien reinsurers which have established U.S. subsidiaries or branches which today are subject to U.S. taxes will obviously severely curtail the U.S. operations carried out of those branches and will write their U.S. reinsurance risks directly by the alien parents or through alien subsidiaries of those parents.

The Administration proposal will produce less revenue in the U.S. and an outflow of capital abroad. This will come about in a number of ways. An insurance contract covering the multinational exposures of an American company currently insured in the U.S. could just as well be written by a foreign subsidiary of an American insurer or an alien company. Reinsurance placed by U.S. insurers with U.S. reinsurers will be less costly if purchased from an unlicensed alien reinsurer. Thus, U.S. policyholders and insurers seeking reinsurance can bypass the increased premiums which U.S. insurers would have to charge to offset the tax increase.

Foreign insurers ceding reinsurance in the U.S. also will have an incentive to place their business abroad. Instead of the reinsurance premium being paid to a U.S.-domiciled reinsurer, it will be paid to an alien insurer. Clearly, the inflow of premium dollars in the balance of insurance trade will dry up.

To recapitulate, a significant tax increase such as that contained in the Administration proposal will:

- Increase the flow of premium dollars to foreign insurance companies unaffected by the tax burden.

- Decrease the flow of foreign-generated premium to the U.S., without necessarily decreasing the extent of U.S. foreign business as premium earned abroad will be kept abroad in subsidiary companies.

- As will be noted below, force a transfer of capital and surplus from the U.S. to support the additional premium being written by foreign insurers that currently is written in the U.S.

The Effect of QRA on the Price of Insurance

What can we anticipate as price increases resulting from the Administration's tax plan?

Throughout this discussion, we have referred to a "significant price increase." Obviously, there is some degree of elasticity in the price of insurance and reinsurance. Frankly, the magnitude of the price increase necessary to force a shift in insurance buying patterns will differ by lines of business and will depend on market conditions. As little as a 2% state premium tax on health insurance creates a substantial incentive for self-insurance. Surely, no one could deny that a 10% cost differential would have an important influence on policyholders' buying decisions or on budgetary decisions by U.S. insurers and reinsurers on whether to leave the foreign-generated premium overseas or repatriate it to the U.S.

Undoubtedly, the lines of insurance most affected by the Treasury proposal would be the "long tail" lines: medical malpractice, general liability, and workers compensation. For many of the affected policyholders, the cost of insurance represents a major (and even at times the major) cost of doing business. Repeated testimony before diverse congressional committees by product manufacturers, stevedoring companies and representatives of medical specialties such as neurosurgeons, gynecologists, anesthesiologists, leave no doubt that the present cost of general liability, workers compensation or medical malpractice insurance is too often forcing entrepreneurs to either curtail planned economic activities or even in some instances, to go out of business altogether.

Based on a methodology developed by Robert A. Bailey, Vice President and Actuary at A.M. Best Company, we have calculated the rate increases necessary to offset the additional tax for those lines to be as follows:*

	Assume 33% Tax Rate	Assume 46% Tax Rate
Medical Malpractice	18%	34%
General Liability	15%	33%
Workers Compensation	11%	21%

These numbers leave no doubt that the Administration's tax plan would seriously impact these "long-tailed" lines of insurance; and, hence, that escaping these increases would become an important strategy of insurance buyers. As noted above, an extensive and sophisticated international insurance network and the mobility of this international commodity would facilitate such an escape.

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* See appendix B for details of these calculations.

No one can predict how much of the premium generated by these lines of insurance would be transferred overseas. Note that even a small percentage would have a dramatic effect on both the balance of payments and the American insurance market, since together these lines generate in excess of $24 billion in annual premium. For example, a relatively small transfer of this business, say 20%, would result in an increase of $4.8 billion in the premium paid by Americans to foreign shores. This would be equivalent to tripling the premiums paid to unlicensed foreign reinsurers.

Furthermore, the foreign generated reinsurance assumed by U.S. insurers would be effectively eliminated (equivalent to $1.3 billion in net premium written in 1983).

But this is not the end of the story.

To support this shift of premium abroad, as well as the additional foreign-source premium to be written by foreign-domiciled subsidiaries, the U.S. insurers and reinsurers will need to export massive surplus funds abroad.* In other words, that portion of U.S. insurers and reinsurers surplus presently dedicated to supporting all premiums will be transferred overseas.

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* Alternatively, surplus funds that alien insurers with U.S. branches would have left in the U.S. will be exported to support the shift to the alien parent/affiliate operations.

We estimate that this will lead to a shift of surplus funds from the U.S. to overseas in excess of $2 billion. This will come from the loss of the presently assumed reinsurance by U.S. companies and from the transfer of insurance premium on U.S. risks which will go abroad.*

This massive export of U.S. insurance surplus will reduce the capacity of the U.S. industry for U.S. business and will also have a serious and direct impact on money markets since it will mean a withdrawal by U.S. insurers of substantial investment funds in the U.S.

Conclusion

In conclusion, we believe that:

- The Administration has failed to recognize the highly fungible nature of this international commodity.

- Enactment of the proposed tax program will seriously aggravate an existing net outflow of insurance funds.

- It will diminish the premium income of U.S. insurers as taxpayers and thus will decrease the additional revenue projections.

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* For a fuller explanation of the derivation of this figure, see Appendix B.

- It will lead to the transfer of large amounts of insurance surplus funds overseas to support the increased activities of foreign subsidiaries of U.S. insurers.

- It will diminish investment income opportunities in the U.S.

Potentially, the Administration's plan could result in a shift in excess of $25 billion* of premium presently written in the U.S. to foreign markets and an additional transfer of $10.9 billion in capital and surplus. Realistically, we estimate a more modest loss, approximately $7 billion in premium and an additional $2.8 billion in surplus funds needed to support the $7 billion transfer. To this large deficit will be added the effect of the large alien reinsurers, which, as noted above, will curtail operation through their U.S. subsidiaries or branches and will write their U.S. business direct; thus, avoiding the effect of QRA.

Mr. Chairman, we urge you and the committee to reject the Administration's proposal.

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* This amount exceeds the premium information on page 23 since the latter data is restricted to the three lines of insurance -- medical malpractice, general liability and workers compensation.

INSURANCE TRANSACTIONS IN THE BALANCE OF TRADE

Insurance is an international commodity which affects the balance of payments. The most common types of insurance traded internationally are property-casualty reinsurance, or insurance purchased by insurance companies, and property-casualty direct insurance, or insurance purchased directly by insured entities.

A. REINSURANCE

Reinsurance Balance of Trade

The U.S. Department of Commerce, Bureau of Economic Analysis, surveys professional reinsurance companies as well as direct insurers with professional reinsurance departments.* The survey requests reinsurance premiums paid (ceded) to foreign insurers, losses recovered from abroad on ceded reinsurance, reinsurance premiums received (assumed) from foreign insurers and losses paid abroad. The survey results for the years 1974 to 1983 are shown in Table A-1.

Net premiums paid to foreign insurers amounted to $2.3 billion in 1983 and represent premiums written less ceding commissions and any other expense reimbursement to the ceding company. Net payments (column 3 of Table A-1) for reinsurance ceded abroad are equal to net premiums paid less losses received. In 1983, the U.S. paid a net of $695.6 million to foreign insurers.

U.S. insurance companies currently reinsure foreign insurers. However, in 1983, the net premiums received from foreign insurers ($1.0 billion) was less than half of the amount ceded by U.S. companies to foreign

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*The survey instrument is report form BE-48 which is sent to companies annually. In 1985, the request was mailed in February and 1984 results will be available by the end of July.

TABLE A-1

U.S. REINSURANCE IMPORTS AND EXPORTS 1974-1983
(Millions of Dollars)

Year	Reinsurance Imports (-)			Reinsurance Exports (+)			
	(1) Net Premiums Paid[a]	(2) Losses Received[b]	(3) Net Payments	(4) Net Premiums Received[a]	(5) Losses Paid[b]	(6) Net Receipts	(7) Net Balance of Payments Effect
1970	448.0	288.0	160.0	251.0	174.0	77.0	(83.0)
1971	474.0	264.0	210.0	310.0	208.0	102.0	(108.0)
1972	513.0	295.0	218.0	402.0	244.0	158.0	(60.0)
1973	575.0	373.0	202.0	476.0	321.0	155.0	(47.0)
1974	679.1	506.4	172.7	559.6	393.6	166.0	(6.7)
1975	899.5	597.9	301.6	683.3	479.5	203.8	(97.8)
1976	1,118.0	619.0	499.0	729.3	536.7	192.6	(306.4)
1977	1,271.7	674.7	597.0	783.7	601.2	182.5	(414.5)
1978	1,567.0	812.7	754.3	803.3	581.3	222.0	(532.3)
1979	1,818.6	984.1	834.5	827.8	610.3	217.5	(617.0)
1980	1,896.7	1,037.1	859.6	896.5	660.6	235.9	(623.7)
1981	2,108.6	1,302.1	806.5	952.6	752.1	200.5	(606.0)
1982(r)	2,100.4	1,322.0	778.4	924.3	736.2	188.1	(590.3)
1983(p)	2,299.7	1,604.1	695.6	1,007.8	818.0	189.8	(505.8)
1984*							
TOTAL	15,759.3	9,460.1	6,299.2	8,168.2	6,169.5	1,998.7	4,300.5

(r) Revised
(p) Preliminary
*1984 data will be provided as soon as it is available.
[a] Net premiums paid or received refer to written reinsurance premiums, not earned premiums, less commissions and other expenses.
[b] Claims paid or received represent actual payments or recovered claims and not losses incurred.

SOURCE: "Reinsurance Transactions of United States Insurance Companies with Insurers Resident Abroad," 1976-1983, U.S. Department of Commerce, Bureau of Economic Analysis, July 1984; 1974-1981, July 1982.

insurers. After reinsurance losses paid to foreign insurers of $818 million, the net reinsurance receipts by insurers in the U.S. were $189.8 million in 1983.

Net reinsurance premium received of $189.8 million less net premium paid of $695.6 million results in a net balance of payments deficit of $505.8 million for reinsurance. This U.S. reinsurance trade deficit increased by almost two orders of magnitude between 1974 and 1983.

Reinsurance differs from other types of insurance in that it can be offered for sale by companies not licensed or admitted in any state in the United States. Reinsurers can be authorized by a state, meaning that the reinsurance transaction will be recognized for annual statement purposes, even if they do not have a U.S. branch or managing general agent in the U.S. Thus, many foreign reinsurance companies are not U.S. taxpayers.

Reinsurance premiums placed offshore are subject to an excise tax. However, transactions with companies domiciled in the United Kingdom (UK), Belgium, France, Italy and other countries are totally or partially exempted from the excise tax due to treaties. In 1983, 40 percent of net reinsurance premiums were paid to companies domiciled in European Communities countries and two-thirds of that to U.K. companies.*

Share of U.S. Market

The reinsurance premiums paid in Table A-1 were net of commissions, etc. paid or allowed to the U.S. ceding company. To gauge the significance of the foreign reinsurance business, it must be stated on a comparable bases to U.S. companies. In Table A-2, the $2.3 billion of premiums paid to unlicensed foreign reinsurers becomes $3.2 billion after adjustment to

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*"Reinsurance Transactions of United States Insurance Companies with Insurers Resident Abroad, 1976-1983," U.S. Department of Commerce, Bureau of Economic Analysis.

TABLE A-2

TOTAL AMERICAN REINSURANCE
Summary of Estimated Net Premiums

Year	Professional Reinsurers		Primary Companies with Professional Reinsurance Departments		Unlicensed Foreign Reinsurers		Total American Reinsurance
	Net Premiums	% of Total	Net Premiums	% of Total	Net Premiums	% of Total	Total Net Premiums
1968	$ 682,000,000	38.0	$ 442,000,000	24.6	$ 670,000,000	37.4	$ 1,794,000,000
1973	1,607,000,000	48.2	805,000,000	24.2	920,000,000	27.6	3,332,000,000
1978	4,332,000,000	50.8	1,955,000,000	22.9	2,248,000,000	26.3	8,535,000,000
1983	6,286,000,000	57.7	1,412,000,000	13.0	3,194,000,000	29.3	10,892,000,000
1984*	6,488,430,000		1,391,456,000				
% Increase 1968-1984	851%		215%		377%		507%

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*1984 data will be provided as soon as it is available.

NOTE: The data from the first two columns were collected from a survey that includes results from 150 professional reinsurance companies, and primary companies with professional reinsurance departments. This report represents the twenty-first Annual Analysis of the U.S. Reinsurance Market conducted by the American Independent Reinsurance Company.

SOURCE: 1968-1983 - John Zech, National Underwriter, Vol. 88, No. 34, August 24, 1984, p. 11; 1984 - Reinsurance Association of America, Reinsurance Underwriting Review, 1984 Premiums and Losses, 1985.

reflect ceding company commissions. This is equivalent to about 29 percent of the total U.S. net reinsurance market, including reinsurance assumed from foreign insurers.

The reinsurance assumed from foreign reinsurers is also net of commissions, etc. Assuming the commissions to foreign companies ceding to the U.S. are the same as U.S. companies ceding abroad, the U.S. assumptions of foreign reinsurance are about $1.4 billion or 13 percent of the Total American Reinsurance Market in Table A-2.

Direct Business

The buyers of direct insurance who purchase from foreign insurers are most likely self-insured companies who purchase insurance for the upper layers of financial risk or companies that have unusual risks that can't be placed in the direct market (called excess or surplus lines).

Insurance companies can write surplus lines insurance without being licensed or admitted to a particular state. U.S. domiciled insurers reported surplus lines premium of $1.3 billion in 1983.* The states levy special surplus lines premium taxes and reported $2.1 billion of surplus lines premium on which taxes were paid. The $800 million difference between the U.S. surplus lines company total and the state total includes a small amount of business written by U.S. domiciled insurers writing some surplus line business and reporting it with their overall premium figures, but is attributable to alien insurers writing U.S. business, such as Underwriters at Lloyds, London and others.**

This amount is grossly understated. It is common knowledge that many such transactions are not reported for premium tax purposes, especially for the direct purchase of insurance from alien insurers. Furthermore, the IRS has estimated that as much as $6 billion in premium is paid to captive insurers each year, most of which are offshore. This number is two times the sum of the available data for 1983 exported reinsurance and surplus lines premium combined.

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*"Surplus Lines Premiums Drop In '83 As A Result Of Steady Competition," National Underwriter, September 7, 1984, p. 3, 22.
**Ibid.

The U.S. Department of Commerce does not collect data on direct insurance purchased by insured entities from foreign insurers. The International Monetary Fund (IMF) reports a net payment figure for direct insurance imports (purchases from abroad) which is shown in Table A-3. The reported figure is net payments, or premiums paid less losses recovered. These figures are based on information collected over 30 years ago, which has been periodically adjusted. While not current like the reinsurance premium data, it indicates the presence of a persistent direct insurance trade deficit. Given the explosive growth in self-insurance and change in liability in the U.S. market, as well as the volume of surplus lines data placed with foreign insurers, the net figures in Table A-3 may well be understated.

The IMF combines the reinsurance trade data from the Department of Commerce (shown previously in Table A-1) with this estimate of direct insurance impacts to obtain a net reinsurance and direct insurance trade balance.* The IMF, thus, reports a net insurance trade deficit of $535 million in 1983, ten times higher than the 1974 figure of $53 million.

Relative Size of Insurance Trade Deficit

The total U.S. Current Account Balance and Balance of Payments have fluctuated between positive and negative values since 1974 (Table A-4). At the same time, the Net Merchandise Trade Balance has been consistently negative but the Net Balance Other Goods, Services and Income has been positive. Nonmerchandise Insurance** is part of the "Other Goods, Services and Income" category and is distinguished as being the only debit item of all those shown in the category in line item detail.

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*The Bureau of Economic Analysis, U.S. Department of Commerce is constantly updating its reinsurance data. The IMF reinsurance data differs slightly from the U.S. Department of Commerce data due to these revisions and differences in dates of reporting.

**Nonmerchandise insurance is used in balance of payments statistics to distinguish insurance purchases per se from the insurance on merchandise imported and exported to and from the U.S.

TABLE A-3

OFFICIAL INSURANCE TRANSACTIONS IN THE U.S. BALANCE OF PAYMENTS (1974-1983)[a]

(Millions of U.S. Dollars)

	(1)	(2)	(3)	(4)	(5)	(6)
				Net Reinsurance and Direct Non-Merchandise Insurance		
Year	Direct Insurance Imports (-) Net U.S. Payments	Reinsurance Imports (-) Net U.S. Payments	Total Imports (-) Net Balance of U.S. Payments	Credit (+) Net U.S. Receipts	Debit (-) Net U.S. Payments	Net Balance of Trade/ Payments
1974	(44)	(176)	(220)	167	(220)	(53)
1975	(44)	(302)	(346)	204	(346)	(142)
1976	(35)	(485)	(520)	196	(520)	(324)
1977	(35)	(595)	(630)	175	(630)	(455)
1978	(38)	(763)	(801)	225	(801)	(576)
1979	(38)	(842)	(878)	207	(879)	(672)
1980	(39)	(872)	(911)	234	(911)	(677)
1981	(35)	(814)	(849)	200	(849)	(649)
1982	(44)	(784)	(828)	199	(828)	(629)
1983	(43)	(695)	(738)	203	(738)	(535)
TOTAL	(395)	(6,328)	(6,721)	2,010	(6,722)	(4,712)

SOURCE: "Detailed Presentation: Transactions Data 1976-1983," Balance of Payments Statistics, International Monetary Fund, Volume 35, Year Book, Part 1, 1984, Volume 29, Year Book, 1978.

[a]The following exchange rates were used to convert each SDR to its dollar equivalent:

1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
1.2021	1.2141	1.1545	1.1675	1.2520	1.2920	1.3015	1.1792	1.1040	1.0690

TABLE A-4

THE RELATIVE SIGNIFICANCE OF NONMERCHANDISE INSURANCE DEFICIT IN THE U.S. BALANCE OF PAYMENTS

(Millions of Dollars)

	Total U.S.[1]				Nonmerchandise Insurance[3]		
Year	(1) Current Account Balance	(2) Balance of Payments Basic	(3) Net Balance Other Goods, Services & Income	(4) Net Merchandise Trade Balance	(5) Net Non-Merchandise Insurance Balance[2]	(6) As % of Current Account Balance	(7) As % of Basic Balance of Payments
1974	2,100	(8,770)	14,850	(5,330)	(53)	NM	.6
1975	18,320	(4,660)	14,150	(9,050)	(142)	NM	3.1
1976	4,370	(10,520)	19,000	(9,320)	(324)	NM	3.1
1977	(14,060)	(35,050)	21,820	(30,890)	(455)	3.2	1.3
1978	(15,490)	(33,480)	24,090	(33,980)	(576)	3.7	1.7
1979	(950)	9,950	32,720	(27,560)	(672)	70.7	NM
1980	1,860	(9,060)	34,940	(25,500)	(677)	NM	7.5
1981	6,620	(1,250)	42,030	(27,980)	(649)	NM	51.9
1982	(9,190)	2,030	36,130	(36,470)	(629)	6.8	NM
1983	(41,580)	(3,950)	28,770	(61,070)	(535)	1.3	13.5
1984	(101,680)	470	17,630	(107,440)	N/A	N/A	N/A

NM - Not Meaningful
N/A - Not Available

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[1] International Financial Statistics, International Monetary Fund, May 1985, December 1983.

[2] "Detailed Presentation: Transactions Data, 1976-1983," Balance of Payments Statistics, International Monetary Fund, Volume 35 Year Book, Part 1, 1984, Volume 29, Year Book, 1978.

[3] Mostly reinsurance, excluding insurance on imported and exported merchandise. Figures represent net balances of payment, meaning premiums paid net of commissions/expenses and less claim payments received.

NOTE: The following exchange rates were used to convert each SDR to its dollar equivalent:

1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
1.2021	1.2141	1.1545	1.1675	1.2520	1.2920	1.3015	1.1792	1.1040	1.0690

Since the current Account and Balance of Payments fluctuate between positive and negative values, the insurance trade balance (always negative) cannot be compared in each year. However, in 1983, the net insurance deficit was 13.5 percent of the Balance of Payments deficit and the insurance deficit accounted for over half the Balance of Payments deficit as recently as 1981.

EMPLOYERS REINSURANCE CORPORATION
Overland Park, KS

To: File

From: Joseph W. Levin

Date: July 1, 1985

Subject: Estimate of Impact of Proposed Treasury Tax Law Change on Property and Casualty Insurance Industry

The following is an outline of my methodology in estimating the impact on the P/C insurance industry of proposed Treasury Tax legislation:

1. From industry aggregate Schedules O and P determined payout factors for the five Schedule P parts and Schedule O and Total for all lines. Where necessary extrapolated remaining payments past last data point.

2. Applied annual interest rate assumptions to payout factors by segment to determine present value of payments in that segment. The discount rate is 100% less the present value of the payments by segment.

3. Determined estimate expense ratios by examining IEE by line.

4. Formula for the needed increase:

$$\text{Needed increase} = \frac{\text{Lost Income due to tax + Tax rate x increase}}{\text{100\% - Expense Ratio}}$$

$$\text{Lost income} = \text{Discount x Tax rate x (100\% - Expense ratio)}$$

In algebraic symbols $X = \frac{(1-E)(D)(T) + (X)(T)}{1 - E}$

where X is indicated increase factor
D is discount
T is tax rate
E is expense ratio
Above values are in decimal form

X, D, E vary by segment and interest assumption

5. Sensitivity was tested by allowing interest rates to vary by ±1% and expense ratios were allowed to vary by ±5% holding interest level. At the 46% tax rate indicated values were sensitive to expense ratio variation.

JWL:env

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LINE OF BUSINESS: AUTO LIABILITY

        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 6.0%

   1      36.20    34.15
   2      29.00    26.52
   3      14.10    11.84
   4       8.90     7.05
   5       5.00     3.74
   6       2.70     1.90
   7       1.60     1.06
   8       0.70     0.44
   9       0.50     0.31
  10       0.30     0.17
  11       0.20     0.11

TOTAL    100.00    87.20


*INDICATED CHANGE @46% TAX RATE=    15.13%
*INDICATED CHANGE @33% TAX RATE=     7.50%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 25.00%

LINE OF BUSINESS: GEN'L LIABILITY

        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 6.0%

   1      12.00    11.32
   2      13.00    11.57
   3      14.00    11.75
   4      13.00    10.30
   5      12.00     8.97
   6       8.00     5.64
   7       6.00     3.99
   8       5.00     3.14
   9       4.00     2.37
  10       4.00     2.23
  11       3.00     1.58
  12       3.00     1.49
  13       2.00     0.94
  14       1.00     0.44

TOTAL    100.00    75.73


*INDICATED CHANGE @46% TAX RATE=    20.87%
*INDICATED CHANGE @33% TAX RATE=    14.30%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 25.00%
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LINE OF BUSINESS: MED MALPRACTICE

        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 6.0%

   1       4.00     3.77
   2       7.00     6.23
   3      10.00     8.40
   4      14.00    11.09
   5       9.00     6.73
   6      13.00     9.16
   7       7.00     4.66
   8       4.00     2.51
   9       4.00     2.37
  10       5.00     2.79
  11       5.00     2.63
  12       4.00     1.99
  13       4.00     1.88
  14       3.00     1.33
  15       3.00     1.25
  16       2.00     0.79
  17 *     2.00     0.74

TOTAL    100.00    60.32


*INDICATED CHANGE @46% TAX RATE=     31.76%
*INDICATED CHANGE @33% TAX RATE=     17.09%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 15.00%

LINE OF BUSINESS: WORKERS COMP

        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 6.0%

   1      27.50    25.94
   2      25.50    22.69
   3      13.00    10.92
   4       8.00     6.34
   5       5.00     3.74
   6       3.00     2.11
   7       3.00     2.00
   8       1.50     0.94
   9       1.50     0.89
  10       1.50     0.84
  11       1.50     0.79
  12       1.50     0.75
  13       1.50     0.70
  14       1.50     0.66
  15       1.50     0.63
  16       1.50     0.59
  17 *     1.50     0.56

TOTAL    100.00    81.09


*INDICATED CHANGE @46% TAX RATE=     18.96%
*INDICATED CHANGE @33% TAX RATE=     10.20%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 15.00%
```

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LINE OF BUSINESS: SCHED P-PART 1E


        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 6.0%

   1      57.00    53.77
   2      25.00    22.25
   3       6.00     5.04
   4       4.00     3.17
   5       3.00     2.24
   6       2.00     1.41
   7       1.00     0.67
   8       0.50     0.31
   9       0.50     0.30
  10       0.50     0.28
  11       0.50     0.26

TOTAL    100.00    89.70


*INDICATED CHANGE @46% TAX RATE=    12.25%
*INDICATED CHANGE @33% TAX RATE=     6.07%


*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 25.00%

LINE OF BUSINESS: SCHED O


        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 6.0%

   1      60.00    56.60
   2      29.00    25.81
   3       3.50     2.94
   4       2.50     1.98
   5       1.50     1.12
   6       1.50     1.06
   7       0.50     0.33
   8       0.50     0.31
   9       0.50     0.30
  10       0.50     0.28

TOTAL    100.00    90.73


*INDICATED CHANGE @46% TAX RATE=    12.44%
*INDICATED CHANGE @33% TAX RATE=     5.79%


*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%
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LINE OF BUSINESS: TOTAL ALL LINES

        PAYMENT    PRESENT VALUE
YEAR    PERCENT    @ 6.0%

   1      45.48     42.91
   2      26.72     23.78
   3       8.67      7.28
   4       5.93      4.78
   5       3.86      2.88
   6       2.64      1.86
   7       1.62      1.07
   8       0.98      0.62
   9       0.88      0.52
  10       0.84      0.47
  11       0.59      0.31
  12       0.42      0.21
  13       0.37      0.17
  14       0.30      0.13
  15       0.24      0.10
  16       0.23      0.09
  17       0.23      0.08 *

TOTAL    100.00     87.10


*INDICATED CHANGE @46% TAX RATE=     15.25%
*INDICATED CHANGE @33% TAX RATE=      7.55%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 25.00%

LINE OF BUSINESS: AUTO LIABILITY

        PAYMENT    PRESENT VALUE
YEAR    PERCENT    @ 6.0%

   1      36.20     34.15
   2      29.80     26.52
   3      14.10     11.84
   4       8.90      7.05
   5       5.00      3.74
   6       2.70      1.90
   7       1.60      1.0
   8       0.70      0.44
   9       0.50      0.36
  10       0.30      0.17
  11       0.20      0.11

TOTAL    100.00     87.20


*INDICATED CHANGE @46% TAX RATE=     20.02%
*INDICATED CHANGE @33% TAX RATE=      8.53%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 35.00%
```

```
LINE OF BUSINESS: GEN'L LIABILITY

        PAYMENT    PRESENT VALUE
YEAR    PERCENT    @ 6.0%

   1      12.00     11.32
   2      13.00     11.57
   3      14.00     11.75
   4      13.00     10.38
   5      12.00      8.97
   6       8.00      5.64
   7       6.00      3.99
   8       5.00      3.14
   9       4.00      2.37
  10       4.00      2.23
  11       3.00      1.58
  12       3.00      1.49
  13       2.00      0.94
  14       1.00      0.44

TOTAL    100.00     75.73


*INDICATED CHANGE @46% TAX RATE=     38.19%
*INDICATED CHANGE @33% TAX RATE=     16.27%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 35.00%

LINE OF BUSINESS: MED MALPRACTICE

        PAYMENT    PRESENT VALUE
YEAR    PERCENT    @ 6.0%

   1       4.00      3.77
   2       7.00      6.23
   3      10.00      8.40
   4      14.00     11.09
   5       9.00      6.73
   6      13.00      9.16
   7       7.00      4.66
   8       4.00      2.51
   9       4.00      2.37
  10       5.00      2.79
  11       5.00      2.63
  12       4.00      1.99
  13       4.00      1.88
  14       3.00      1.33
  15       3.00      1.25
  16       2.00      0.79
  17       2.00      0.74

TOTAL    100.00     68.32


*INDICATED CHANGE @46% TAX RATE=     37.69%
*INDICATED CHANGE @33% TAX RATE=     18.67%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 25.00%
```

```
LINE OF BUSINESS: WORKERS COMP

        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 6.0%

   1      27.50     25.94
   2      25.50     22.69
   3      13.00     10.92
   4       8.00      6.34
   5       5.00      3.74
   6       3.00      2.11
   7       3.00      2.00
   8       1.50      0.94
   9       1.50      0.89
  10       1.50      0.84
  11       1.50      0.79
  12       1.50      0.75
  13       1.50      0.70
  14       1.50      0.66
  15       1.50      0.63
  16       1.50      0.59
  17       1.50      0.56

TOTAL    100.00     81.09


*INDICATED CHANGE @46% TAX RATE=    22.50%
*INDICATED CHANGE @33% TAX RATE=    11.14%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 25.00%

LINE OF BUSINESS: SCHED P-PART 1E

        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 6.0%

   1      57.00     53.77
   2      25.00     22.25
   3       6.00      5.04
   4       4.00      3.17
   5       3.00      2.24
   6       2.00      1.41
   7       1.00      0.67
   8       0.50      0.31
   9       0.50      0.30
  10       0.50      0.28
  11       0.50      0.26

TOTAL    100.00     89.70


*INDICATED CHANGE @46% TAX RATE=    16.21%
*INDICATED CHANGE @33% TAX RATE=     6.90%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 35.00%
```

```
LINE OF BUSINESS: SCHED O

        PAYMENT    PRESENT VALUE
YEAR    PERCENT    @ 6.0%

   1      60.00      56.60
   2      29.00      25.81
   3       3.50       2.94
   4       2.50       1.98
   5       1.50       1.12
   6       1.50       1.06
   7       0.50       0.33
   8       0.50       0.31
   9       0.50       0.30
  10       0.50       0.28

TOTAL    100.00      90.73


*INDICATED CHANGE @46% TAX RATE=     10.20%
*INDICATED CHANGE @33% TAX RATE=      6.80%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 40.00%

LINE OF BUSINESS: TOTAL ALL LINES

        PAYMENT    PRESENT VALUE
YEAR    PERCENT    @ 6.0%

   1      45.48      42.91
   2      26.72      23.78
   3       8.67       7.28
   4       5.93       4.70
   5       3.86       2.88
   6       2.64       1.86
   7       1.62       1.07
   8       0.98       0.62
   9       0.88       0.52
  10       0.84       0.47
  11       0.59       0.31
  12       0.42       0.21
  13       0.37       0.17
  14       0.30       0.13
  15       0.24       0.10
  16       0.23       0.09
  17       0.23       0.08

TOTAL    100.00      87.18


*INDICATED CHANGE @46% TAX RATE=     20.17%
*INDICATED CHANGE @33% TAX RATE=      8.59%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 35.00%
```

```
LINE OF BUSINESS: AUTO LIABILITY

       PAYMENT   PRESENT VALUE
YEAR   PERCENT   @ 6.0%

   1     36.20     34.15
   2     29.80     26.52
   3     14.10     11.84
   4      8.90      7.05
   5      5.00      3.74
   6      2.70      1.90
   7      1.60      1.06
   8      0.70      0.44
   9      0.50      0.30
  10      0.30      0.17
  11      0.20      0.11

TOTAL   100.00     87.28


*INDICATED CHANGE @46% TAX RATE=    17.07%
*INDICATED CHANGE @33% TAX RATE=     7.94%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%

LINE OF BUSINESS: GEN'L LIABILITY


       PAYMENT   PRESENT VALUE
YEAR   PERCENT   @ 6.0%

   1     12.00     11.32
   2     13.00     11.57
   3     14.00     11.75
   4     13.00     10.30
   5     12.00      8.97
   6      8.00      5.64
   7      6.00      3.99
   8      5.00      3.14
   9      4.00      2.37
  10      4.00      2.23
  11      3.00      1.58
  12      3.00      1.49
  13      2.00      0.94
  14      1.00      0.44

TOTAL   100.00     75.73


*INDICATED CHANGE @46% TAX RATE=    32.56%
*INDICATED CHANGE @33% TAX RATE=    15.15%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%
```

```
LINE OF BUSINESS: MED MALPRACTICE

        PAYMENT   PRESENT VALUE
YEAR    PERCENT    @ 6.0%

   1       4.00      3.77
   2       7.00      6.23
   3      10.00      8.40
   4      14.00     11.09
   5       9.00      6.73
   6      13.00      9.16
   7       7.00      4.66
   8       4.00      2.51
   9       4.00      2.37
  10       5.00      2.79
  11       5.00      2.63
  12       4.00      1.99
  13       4.00      1.88
  14       3.00      1.33
  15       3.00      1.25
  16       2.00      0.79
  17       2.00      0.74

TOTAL    100.00     68.32


*INDICATED CHANGE @46% TAX RATE=     34.29%
*INDICATED CHANGE @33% TAX RATE=     17.79%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 20.00%

LINE OF BUSINESS: WORKERS COMP

        PAYMENT   PRESENT VALUE
YEAR    PERCENT    @ 6.0%

   1      27.50     25.94
   2      25.50     22.69
   3      13.00     10.92
   4       8.00      6.34
   5       5.00      3.74
   6       3.00      2.11
   7       3.00      2.00
   8       1.50      0.94
   9       1.50      0.89
  10       1.50      0.84
  11       1.50      0.79
  12       1.50      0.75
  13       1.50      0.70
  14       1.50      0.66
  15       1.50      0.63
  16       1.50      0.59
  17       1.50      0.56

TOTAL    100.00     81.09


*INDICATED CHANGE @46% TAX RATE=     20.47%
*INDICATED CHANGE @33% TAX RATE=     10.62%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 20.00%
```

```
LINE OF BUSINESS: SCHED P-PART 1E

        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 6.0%

   1      57.00     53.77
   2      25.00     22.25
   3       6.00      5.04
   4       4.00      3.17
   5       3.00      2.24
   6       2.00      1.41
   7       1.00      0.67
   8       0.50      0.31
   9       0.50      0.30
  10       0.50      0.28
  11       0.50      0.26

TOTAL    100.00     89.70


*INDICATED CHANGE @46% TAX RATE=     13.82%
*INDICATED CHANGE @33% TAX RATE=      6.43%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%

LINE OF BUSINESS: SCHED O

        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 6.0%

   1      60.00     56.60
   2      29.00     25.81
   3       3.50      2.94
   4       2.50      1.98
   5       1.50      1.12
   6       1.50      1.06
   7       0.50      0.33
   8       0.50      0.31
   9       0.50      0.30
  10       0.50      0.28

TOTAL    100.00     90.73


*INDICATED CHANGE @46% TAX RATE=     14.59%
*INDICATED CHANGE @33% TAX RATE=      6.21%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 35.00%
```

```
LINE OF BUSINESS: TOTAL ALL LINES


       PAYMENT   PRESENT VALUE
YEAR   PERCENT   @ 6.0%

   1     45.48    42.91
   2     26.72    23.78
   3      8.67     7.28
   4      5.93     4.70
   5      3.86     2.88
   6      2.64     1.86
   7      1.62     1.07
   8      0.98     0.62
   9      0.88     0.52
  10      0.84     0.47
  11      0.59     0.31
  12      0.42     0.21
  13      0.37     0.17
  14      0.30     0.13
  15      0.24     0.10
  16      0.23     0.09
  17      0.23     0.08

TOTAL   100.00    87.18


*INDICATED CHANGE @46% TAX RATE=    17.20%
*INDICATED CHANGE @33% TAX RATE=     8.00%


*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO TAX RATE
 EXPENSE RATIO= 30.00%

LINE OF BUSINESS: AUTO LIABILITY


       PAYMENT   PRESENT VALUE
YEAR   PERCENT   @ 5.0%

   1     36.20    34.48
   2     29.80    27.03
   3     14.10    12.18
   4      8.90     7.32
   5      5.00     3.92
   6      2.70     2.01
   7      1.60     1.14
   8      0.70     0.47
   9      0.50     0.32
  10      0.30     0.18
  11      0.20     0.12

TOTAL   100.00    89.17


*INDICATED CHANGE @46% TAX RATE=    14.53%
*INDICATED CHANGE @33% TAX RATE=     6.76%


*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%
```

```
LINE OF BUSINESS: GEN'L LIABILITY


       PAYMENT    PRESENT VALUE
YEAR   PERCENT    @ 5.0%

   1     12.00     11.43
   2     13.00     11.29
   3     14.00     12.09
   4     13.00     10.70
   5     12.00      9.40
   6      8.00      5.97
   7      6.00      4.26
   8      5.00      3.38
   9      4.00      2.58
  10      4.00      2.46
  11      3.00      1.75
  12      3.00      1.67
  13      2.00      1.06
  14      1.00      0.51

TOTAL   100.00     79.05


*INDICATED CHANGE @46% TAX RATE=     28.11%
*INDICATED CHANGE @33% TAX RATE=     13.08%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%

LINE OF BUSINESS: MED MALPRACTICE


       PAYMENT    PRESENT VALUE
YEAR   PERCENT    @ 5.0%

   1      4.00      3.81
   2      7.00      6.35
   3     10.00      8.64
   4     14.00     11.52
   5      9.00      7.05
   6     13.00      9.70
   7      7.00      4.97
   8      4.00      2.71
   9      4.00      2.58
  10      5.00      3.07
  11      5.00      2.92
  12      4.00      2.23
  13      4.00      2.12
  14      3.00      1.52
  15      3.00      1.44
  16      2.00      0.92
  17      2.00      0.87

TOTAL   100.00     72.42


*INDICATED CHANGE @46% TAX RATE=     29.85%
*INDICATED CHANGE @33% TAX RATE=     15.49%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0 EXP. RATIO-TAX RATE
 EXPENSE RATIO= 20.00%
```

```
LINE OF BUSINESS: WORKERS COMP

       PAYMENT    PRESENT VALUE
YEAR   PERCENT    @ 5.0%

   1     27.50     26.19
   2     25.50     23.13
   3     13.00     11.23
   4      8.00      6.58
   5      5.00      3.92
   6      3.00      2.24
   7      3.00      2.13
   8      1.50      1.02
   9      1.50      0.97
  10      1.50      0.92
  11      1.50      0.88
  12      1.50      0.84
  13      1.50      0.80
  14      1.50      0.76
  15      1.50      0.72
  16      1.50      0.69
  17      1.50      0.65

TOTAL   100.00     83.67


*INDICATED CHANGE @46% TAX RATE=     17.67%
*INDICATED CHANGE @33% TAX RATE=      9.17%


*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 20.00%

LINE OF BUSINESS: SCHED P-PART 1E


       PAYMENT    PRESENT VALUE
YEAR   PERCENT    @ 5.0%

   1     57.00     54.29
   2     25.00     22.68
   3      6.00      5.18
   4      4.00      3.29
   5      3.00      2.35
   6      2.00      1.49
   7      1.00      0.71
   8      0.50      0.34
   9      0.50      0.32
  10      0.50      0.31
  11      0.50      0.29

TOTAL   100.00     91.25


*INDICATED CHANGE @46% TAX RATE=     11.74%
*INDICATED CHANGE @33% TAX RATE=      5.46%


*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%
```

```
LINE OF BUSINESS: SCHED O

        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 5.0%

   1      60.00     57.14
   2      29.00     26.30
   3       3.50      3.02
   4       2.50      2.06
   5       1.50      1.18
   6       1.50      1.12
   7       0.50      0.36
   8       0.50      0.34
   9       0.50      0.32
  10       0.50      0.31

TOTAL    100.00     92.15


*INDICATED CHANGE @46% TAX RATE=    12.35%
*INDICATED CHANGE @33% TAX RATE=     5.26%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 35.00%

LINE OF BUSINESS: TOTAL ALL LINES


        PAYMENT   PRESENT VALUE
YEAR    PERCENT   @ 5.0%

   1      45.48     43.31
   2      26.72     24.24
   3       8.67      7.49
   4       5.93      4.88
   5       3.86      3.02
   6       2.64      1.97
   7       1.62      1.15
   8       0.98      0.67
   9       0.88      0.57
  10       0.84      0.52
  11       0.59      0.35
  12       0.42      0.24
  13       0.37      0.20
  14       0.38      0.15
  15       0.24      0.12
  16       0.23      0.10
  17       0.23      0.10

TOTAL    100.00     89.08


*INDICATED CHANGE @46% TAX RATE=    14.65%
*INDICATED CHANGE @33% TAX RATE=     6.82%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%
```

```
LINE OF BUSINESS: AUTO LIABILITY


        PAYMENT    PRESENT VALUE
YEAR    PERCENT    @ 7.0%

   1      36.20     33.83
   2      29.80     26.03
   3      14.10     11.51
   4       8.90      6.79
   5       5.00      3.56
   6       2.70      1.80
   7       1.60      1.00
   8       0.70      0.41
   9       0.50      0.27
  10       0.30      0.15
  11       0.20      0.10

TOTAL    100.00     85.45



*INDICATED CHANGE @46% TAX RATE=    19.52%
*INDICATED CHANGE @33% TAX RATE=     9.08%


*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%


LINE OF BUSINESS: GEN'L LIABILITY


        PAYMENT    PRESENT VALUE
YEAR    PERCENT    @ 7.0%

   1      12.00     11.21
   2      13.00     11.35
   3      14.00     11.43
   4      13.00      9.92
   5      12.00      8.56
   6       8.00      5.33
   7       6.00      3.74
   8       5.00      2.91
   9       4.00      2.18
  10       4.00      2.03
  11       3.00      1.43
  12       3.00      1.33
  13       2.00      0.83
  14       1.00      0.39

TOTAL    100.00     72.64



*INDICATED CHANGE @46% TAX RATE=    36.71%
*INDICATED CHANGE @33% TAX RATE=    17.98%


*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%
```

```
LINE OF BUSINESS: MED MALPRACTICE


       PAYMENT   PRESENT VALUE
YEAR   PERCENT   @ 7.0%

   1      4.00      3.74
   2      7.00      6.11
   3     10.00      8.16
   4     14.00     10.68
   5      9.00      6.42
   6     13.00      8.66
   7      7.00      4.36
   8      4.00      2.33
   9      4.00      2.18
  10      5.00      2.54
  11      5.00      2.38
  12      4.00      1.78
  13      4.00      1.66
  14      3.00      1.16
  15      3.00      1.09
  16      2.00      0.68
  17      2.00      0.63

TOTAL   100.00     64.56


*INDICATED CHANGE @46% TAX RATE=    38.36%
*INDICATED CHANGE @33% TAX RATE=    19.93%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 20.00%

LINE OF BUSINESS: WORKERS COMP


       PAYMENT   PRESENT VALUE
YEAR   PERCENT   @ 7.0%

   1     27.50     25.70
   2     25.50     22.27
   3     13.00     10.61
   4      8.00      6.10
   5      5.00      3.56
   6      3.00      2.00
   7      3.00      1.87
   8      1.50      0.87
   9      1.50      0.82
  10      1.50      0.76
  11      1.50      0.71
  12      1.50      0.67
  13      1.50      0.62
  14      1.50      0.58
  15      1.50      0.54
  16      1.50      0.51
  17      1.50      0.47

TOTAL   100.00     78.66


*INDICATED CHANGE @46% TAX RATE=    23.10%
*INDICATED CHANGE @33% TAX RATE=    11.99%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 20.00%
```

```
LINE OF BUSINESS: SCHED P-PART 1L

        PAYMENT    PRESENT VALUE
YEAR    PERCENT    @ 7.0%

   1      57.00     53.27
   2      25.00     21.84
   3       6.00      4.90
   4       4.00      3.05
   5       3.00      2.14
   6       2.00      1.33
   7       1.00      0.62
   8       0.50      0.29
   9       0.50      0.27
  10       0.50      0.25
  11       0.50      0.24

TOTAL   100.00     88.20


*INDICATED CHANGE @46% TAX RATE=     15.83%
*INDICATED CHANGE @33% TAX RATE=      7.37%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%

LINE OF BUSINESS: SCHED O

        PAYMENT    PRESENT VALUE
YEAR    PERCENT    @ 7.0%

   1      60.00     56.07
   2      29.00     25.33
   3       3.50      2.86
   4       2.50      1.91
   5       1.50      1.07
   6       1.50      1.00
   7       0.50      0.31
   8       0.50      0.29
   9       0.50      0.27
  10       0.50      0.25

TOTAL   100.00     89.36


*INDICATED CHANGE @46% TAX RATE=     16.74%
*INDICATED CHANGE @33% TAX RATE=      7.13%

*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 35.00%
```

```
LINE OF BUSINESS: TOTAL ALL LINES

      PAYMENT   PRESENT VALUE
YEAR  PERCENT   @ 7.0%

   1    45.48    42.51
   2    26.72    23.34
   3     8.67     7.08
   4     5.93     4.53
   5     3.06     2.75
   6     2.64     1.76
   7     1.62     1.01
   8     0.98     0.57
   9     0.88     0.48
  10     0.84     0.43
  11     0.59     0.28
  12     0.42     0.19
  13     0.37     0.15
  14     0.30     0.12
  15     0.24     0.09
  16     0.23     0.08
  17     0.23     0.07

TOTAL   100.00    85.44



*INDICATED CHANGE @46% TAX RATE=    19.53%
*INDICATED CHANGE @33% TAX RATE=     9.09%


*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)/(1.0-EXP. RATIO-TAX RATE
 EXPENSE RATIO= 30.00%
```

```
0: "ESTIMATE OF INCREASED PREMIUM DUE TO TREASURY TAX PROPOSAL":
1: dim P[17,7],W[7],E[7],Y[7],L$[7,20],B[18,2]
2: asgn "BESTDATA",1;sread 1,P[*],W[*],E[*],Y[*],L$
3: ent "INTEREST RATE",V;prt V
4: 1+V/100)W;1/W)W
5: for C=1 to 7
6: Y[C])N
7: for I=1 to N
8: P[I,C])B[I,1]
9: prnd(B[I,1]*W^I,-2))B[I,2];B[I,2]+r2)r2
10: B[I,1]+r1)r1;next I
11: gsb "P"
12: next C
13: wtb 701,12
14: stp
15: "P":
16: fmt 1,"LINE OF BUSINESS: ",c20,2/
17: wrt 701.1,L$[C]
18: fmt 1,7x,"PAYMENT   PRESENT VALUE";wrt 701.1
19: fmt 1,"YEAR   PERCENT   @",f4.1,"%",/
20: wrt 701.1,V
21: for I=1 to N
22: fmt 1,f4.0,3x,f7.2,f9.2
23: wrt 701.1,I,B[I,1],B[I,2];next I
24: wrt 701
25: fmt 1,"TOTAL",2x,f7.2,f9.2,3/;wrt 701.1,r1,r2
26: fmt 1,"*INDICATED CHANGE @46% TAX RATE= ",f8.2,"%"
27: fmt 2,"*INDICATED CHANGE @33% TAX RATE= ",f8.2,"%",2/
28: fmt 3,"*INDICATED CHANGE FACTOR=(TAX RATE*DISC)*(1.0-EXP. RATIO)",
29: fmt 4,"/(1.0-EXP. RATIO-TAX RATE)"
30: fmt 5," EXPENSE RATIO= ",f5.2,"%"
31: 1-r2/100)r3
32: E[C]*.46*r3/(E[C]-.46))r1
33: E[C]*.33*r3/(E[C]-.33))r2
34: wrt 701.1,100r1
35: wrt 701.2,100r2
36: wrt 701.3;wrt 701.4;wrt 701.5,100-100L[C]
37: for I=1 to N;for J=1 to 2;0)B[I,J];next J;next I
38: 0)r1)r2)r3
39: wtb 701,12
40: ret
*22851
```

PERCENT INCREASES NEEDED TO OFFSET
LOSS IN INCOME DUE TO TREASURY II
PROPOSAL

Prepared by	JBs	7/1
Approved by		

		33% TAX RATE			46% TAX RATE		
	EXPENSE RATIO	ANNUAL INTEREST RATE 5%	6%	7%	ANNUAL INTEREST RATE 5%	6%	7%
AUTO LIABILITY							
	25%		7.5			15.1	
	30	6.8	7.9	9.1	14.5	17.1	19.5
	35		8.5			20.0	
GENERAL LIABILITY							
	25%		14.3			28.9	
	30	13.1	15.2	17.1	28.1	32.6	36.7
	35		16.3			38.2	
MED MALPRACTICE							
	15%		17.1			31.8	
	20	15.5	17.8	19.9	29.9	34.3	38.4
	25		18.7			37.7	
WORKERS COMP							
	15%		10.2			19.0	
	20	9.2	10.6	12.0	17.7	20.5	23.1
	25		11.1			22.5	
SCHED P - PART 1G							
	25%		6.1			12.3	
	30	5.5	6.4	7.4	11.7	13.8	15.8
	35		6.9			16.2	
SCHEDULE O							
	30%		5.8			12.4	
	35	5.3	6.2	7.1	12.4	14.6	16.7
	40		6.8			18.3	
TOTAL ALL LINES							
	25%		7.6			15.3	
	30	6.8	8.0	9.1	14.7	17.2	19.5
	35		8.6			20.2	

SURPLUS OUTFLOW TO SUPPORT PREMIUM OUTFLOW

In 1984, U.S. professional reinsurers had a premium-to-surplus ratio of 1.5 to 1.* What this means is that every dollar of net premium written was supported by $.67 in surplus. Even if one assumes that alien insurers will write business at a premium-to-surplus ratio of 2.5 to 1 (a ratio more like that of primary companies), $.40 in surplus is required to write each dollar of premium.

The capital outflow associated with reinsurance premium lost to alien companies can be calculated as follows:

Premium Outflow X .4

The minimum premium outflow (based on 1983 premium levels) consist of:

Reinsurance currently assumed from abroad:	$1.3 billion**
Additional reinsurance on U.S. risks ceded abroad:	4.8 billion***
Premium outflow:	$7.1 billion

.4 X $7.1 billion = $2.84 billion

If all casualty business is affected (if alien reinsurers and insurers expand capacity sufficiently), an additional $20.2 billion in premium could flow out of the U.S.

.4 X $20.2 billion = $8.08 billion

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*Reinsurance Association of America, Reinsurance Underwriting Review, 1984 Premiums and Losses, 1985, pp. 8-12.
**See Appendix A, pp. 4-7.
***See Statement, p.

THE ECONOMIC ROLE OF PROPERTY-CASUALTY INSURANCE

What is Insurance?

In the introduction to this statement, we called property and casualty (P/C) insurance "the lubrication which permits the economy to operate." Why or how is that so?

A generic definition of insurance, stated by Irving Pfeffer, is as follows[1]:

> "Insurance is a device for the reduction of the uncertainty of one party, called the insured, through the transfer of particular risks to another party, called the insurer, who offers a restoration, at least in part, of economic losses suffered by the insured."

Insurable risks are what is known as "pure" as opposed to speculative risks. In other words, "to the entity facing the exposure, the possible outcomes are adverse (loss) or neutral (no loss), but in no case beneficial."[2]

Firms and individuals purchase insurance to avoid the costs arising from losses that actually occur and from the fact that losses might occur. Without insurance, the financial impact of a loss falls directly on the entity experiencing the loss. The degree of impact could range from minor inconvenience to losses so large that the entity ceases to exist. Without insurance, "Society as a whole loses when its members suffer financial losses that are not offset by gains to other members of society. Society loses directly because society is the sum of its parts, and one or more parts are worse off than previously. Society loses indirectly if the affected parts pay less tax because of their losses [e.g., through interruption or shutdown of a business], if prices rise because total production in society is lessened, if welfare or other special assistance costs rise, or if there is social unrest because the lives of the affected society members are disrupted."[3]

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[1] Irving Pfeffer, Insurance and Economic Theory, Richard D. Irwin, Inc., Homewood, Illinois, 1956, p. 53.

[2] C. Arthur Williams, et al., Principles of Insurance and Risk Management, Vol. 1, American Institute for Property and Liability Underwriters, Malvern, Pennsylvania, 1981, p. 4.

For risks covered by P/C insurance, relatively few firms or families will experience a particular type of loss. However, all entities facing the possibility of a loss face the uncertainty as to whether they will be among those who suffer the loss. This uncertainty leads to less than optimum resource allocation, as well as causing stress for individuals. The cost of this uncertainty, or from the fact that losses might occur, alters the behavior of the firm, causing avoidance of some "risky" activities, emphasis on the short-term, and excessive liquidity with associated reductions in capital investment.[4]

The Difference between Insurance and "Self-Insurance"

The administrator's proposal seeks to make firms indifferent between the purchase of insurance and "self-insurance" from a tax perspective. However, from the viewpoint of the Internal Revenue Service (IRS) and, consistent with economic theory and principles of risk management, purchase of insurance and self-insurance are two entirely different states or conditions.

Consistent with the generic definition above, commercial property-casualty insurance is a mechanism for transferring the financial uncertainty arising from pure risks faced by one firm to another in exchange for an insurance premium. Pure risks are caused by the possibility of certain types of occurrences that only may have adverse financial consequences.

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[3] Op cit, p. 11.
[4] Op cit, pp. 11-12.

The key element necessary for the existence of an insurance transaction is the *transfer* of financial uncertainty. A firm that retains its risks or places its risks in an insurance company it owns (both forms of "self-insurance") is not transferring or relieving itself of financial uncertainty. In fact, "self-insurance" is equivalent to no insurance because the firm still holds the benefits and burdens of retaining the financial consequences of its own risks.

From the standpoint of the insured firm, the transfer of financial uncertainty means that no matter what insured perils occur, the financial consequences are known in advance. Thus, the insured, for the price of the premium, is protected, within the limits of the policy, from having to worry about and provide for the financial consequences of losses from a defined hazard or risk.

A true transfer of risk requires another risk-bearer to replace the insured. A fund or reserve, *established by the insured*, is a mechanism for "self-insurance." Although a firm may elect to retain or "self-insure" certain risks, it *cannot* insure itself.[5]

The basis of the IRS's disallowance of a deduction for insurance premium paid by firms to their captive insurance companies (companies owned by or within the same economic family as the insured) is that no insurance transaction effectively occurs unless there is transfer of risk. Captive insurance is a form of self-insurance or managing retained risk. So long as the firm does not transfer to another the ultimate responsibility for the financial consequences of its risks, it remains the risk bearer and faces the uncertainty of each year's financial losses. Thus, no insurance was purchased and no deduction is allowed.[6]

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[5] See I.H. Plotkin, *On the Nature of Captive Insurance*, report to the Commissioner of Internal Revenue in the Matter of Gulf Oil Corporation v. Commissioner, U.S. Tax Court, Docket No. 22499-82, July 13, 1984.

[6] See *Beech Aircraft Corp. v. United States*, U.S. District Court of Kansas, Civil No. 82-1369, and *Stearns-Roger Corp. v. United States*, U.S. District Court of Colorado, Civil No. 81-C-2046.

How Does Insurance Lubricate the Economy?

Insurance facilitates commerce and makes society as a whole better off. The benefits accrue to individuals and society through indemnification for losses, reduction in uncertainty and generation of funds for the capital markets.

Individuals and firms indemnified for losses are restored in part or in full to their economic position prior to the loss. This enhances production, consumption and tax revenues.

The more important benefit of insurance is the reduction in uncertainty to society as a whole. As discussed above, when the insured transfers its risk to an insurer, its uncertainty is eliminated along with the adverse reactions to risk. The insurer accepting the risk has less uncertainty than the collective uncertainty of the individual insureds. Thus, the level of uncertainty in society as a whole is reduced.[7]

The reduction in uncertainty not only eliminates the stress to individuals associated with the risk, but also eliminates inefficiencies in the use of existing resources. Further, the reduction in uncertainty fosters investment in new capital stock because the risk to investors is reduced, planning periods for investment are lengthened, credit is more readily available and the need for liquidity is reduced. "Insurance, therefore, results in more nearly optimum production, price levels and price structures."[8]

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[7] C. Arthur Williams, Jr. and Richard M. Heins, "Benefits and Costs of Insurance," Risk Management and Insurance, Fifth Edition, McGraw-Hill, 1985, pp. 216-218. The author notes that while the uncertainty of the insurer is less than the insured, the insurer still has uncertainty as to the difference between expected losses and actual losses that will occur during an exposure period and, more importantly, uncertainty about the level of expected losses.

[8] Ibid.

Peter F. Drucker recognized the importance of insurance to industrial economies:[9]

> "One of the greatest achievements of the mercantile age was the conversion of many of these physical risks into something that could be predicted and provided against. It is no exaggeration to say that without insurance an industrial economy would not function at all."

Insurance also enhances the credit mechanism through various financial guaranty products, protects against deterioration in property values and facilitates international trade. Further the presence of insurance itself can alter the character of the risk insured against through loss prevention activities instituted by the insurance company.[10]

The insurance industry also is a major source of funds for capital investment in the U.S. economy. Insurance companies have a fiduciary responsibility to their policyholders to safeguard funds held in their behalf. The National Association of Insurance Commissions specifies the types of investments it will consider as admitted assets (for Annual Statement purposes).[11] Admitted assets for property-casualty companies include investment-grade bonds, preferred and common stock, cash equivalents and limited real estate investment.

As of December 1984, cash and invested assets of property-casualty companies was $216.9 billion, an increase of $6.1 billion over December 1983 (Table C-1). Increases in reserves and surplus increase the funds invested by insurers in the capital markets. Insurers, collectively, can make more funds available for the capital markets than would be the case

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[9] Peter F. Drucker, The New Society, Harper & Row, Inc., New York, 1950, p. 57.

[10] Irving Pfeffer, Insurance and Economic Theory, Richard D. Irwin, Inc., Homewood, Illinois, 1956, pp. 114-119.

[11] National Association of Insurance Commissioners, Valuation of Securities.

TABLE C-1

INVESTED ASSETS OF PROPERTY-CASUALTY COMPANIES
($ Billions)

	1984	1983
Bonds		
Government Securities	$ 36.7	$ 29.5
States, Territories, Possessions	10.7	11.6
Political Subdivision of States	14.5	15.0
Special Revenue & Other Non-Guaranteed Governments	58.7	60.1
Public Utilities	6.6	6.3
Industrial & Miscellaneous[1]	15.6	13.4
Parents, Subsidiaries, Affiliates	0.5	0.5
TOTAL BONDS	$143.4	$136.4
Preferred Stocks		
Public Utilities	$ 5.6	$ 6.2
Banks, Trust, Insurance Companies	0.8	0.5
Industrial & Miscellaneous	2.5	2.8
Parents, Subsidiaries, Affiliates	0.2	0.1
TOTAL PREFERRED STOCK	$ 9.2	$ 9.6
Common Stocks		
Public Utilities	$ 3.2	$ 3.2
Banks, Trust, Insurance Companies	2.9	3.6
Industrial & Miscellaneous	20.3	22.9
Parents, Subsidiaries, Affiliates	12.0	27.6
TOTAL COMMON STOCK	$ 38.4	$ 57.3
Real Estate	$ 3.2	$ 3.2
Cash on Hand/Deposit	$ 3.1	$ 2.6
Short-Term Investments	$ 17.9	$ 13.7
Other	$ 1.7	$ 1.6
TOTAL CASH AND INVESTMENT ASSETS[2]	$216.9	$210.8

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[1] Includes railroads.

[2] Totals may not sum due to rounding.

SOURCE: A. M. Best Company, Oldwick, New Jersey.

for an equivalent level of risk that was self-insured.[12] The reason for this is the lower uncertainty for insurers than the uncertainty facing individuals and the associated lower levels of liquidity (manifested by investments in cash and short-term securities).

What Are the Costs of Insurance to Society?

On balance, the benefits to society from insurance far outweigh its costs.

The costs of insurance related to the resources consumed in its production include acquisition expense, general and administrative expense, loss control expense, loss adjustment expense, and the cost of capital. Other expenses levied on insurance companies include state premium taxes, licensing and other fees, and federal income tax. In 1984, property-casualty companies had net premiums earned of $115 billion, losses incurred of $88.7 billion (77 percent), loss adjustment expense of $12.9 billion (11 percent), other underwriting expense of $33.2 billion (29 percent), for a net underwriting loss of $19.6 billion (a negative underwriting profit margin -- 17 percent).[13]

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[12] C. Arthur Williams, Jr. and Richard M. Heins, Risk Management and Insurance, McGraw-Hill, 1985, p. 218.

[13] A. M. Best Company, Oldwick, New Jersey. Investment income and realized capital gains were not sufficient to offset underwriting losses and other charges against income. Thus, the P/C industry had profit before federal tax of -$1.7 billion.

THE FUNCTION OF RESERVES IN PROPERTY-CASUALTY INSURANCE

TYPES OF RESERVES

Reserves are a major component of the capital used and needed to support an insurer's ability to assume risks.

Reserves are established to provide for liabilities generated by underwriting. The major categories or types of reserves established by property-casualty (P/C) companies are the following:

- Unearned premium reserves, which provide for the potential need to return premium to policyholders in the event of a cancellation or to purchase reinsurance for the balance of the policy;

- Loss and loss expense reserves, which provide for potential claims that must be paid under the policy; different reserves are established for claims with different degrees of certainty and knowledge.

1. Unearned Premium Reserve

In the early 19th century, a common practice in the insurance industry was to recognize premium as revenue fully at the time the policy was written. Since insurance policies generally are designed to be in force from one to many years, this was tantamount to recognizing revenue before the insurance service had been provided. Starting in 1848, the insurance companies operating in New York were required to establish a liability reserve sufficient to reinsure outstanding risk and this is now the general rule for all states and lines of business.

The unearned premium reserve is equal to the amount of premium written that has not yet been earned or the amount that would be refunded to policyholders if the policy were cancelled. Insurance statutes and regulations do not allow reducing the unearned premium reserve for prepaid expenses, which includes agents' commission, taxes, and other acquisition costs. Further, according to state insurance accounting requirements, these prepaid expenses cannot be shown as an asset on the balance sheet, although they can be shown as a prepaid expense asset under Generally Accepted Accounting Principles (GAAP).

2. Loss and Loss Expense Reserves

The calculation of underwriting profit or loss for an insurance company's accounting period requires that premium earned during the period be matched against the costs incurred during the period. Insurance accounting is on a cash basis for expenses that have been paid and on an accrual basis for expenses that have been incurred and not paid. Thus, an insurer is required to deduct the full amount of commission and other acquisition cost against premium earned as well as both the loss and loss expense incurred as of the statement date.

At the end of an accounting period, the ultimate value and timing of losses and loss expense payments is unknown. Ultimate loss and loss expenses must be estimated and reserves established for the portion that has been incurred but not yet paid out in claims. For most property-casualty lines, the two major loss-reserve categories are:

- Case reserves for future payments on claims that have been reported and are currently outstanding that are believed to require future payments.

- Incurred But Not Reported (IBNR) reserves or potential liability for claims arising out of events which have already occurred but are not yet known or reported to the insurer.

Non-life companies use a variety of loss-reserving methods, several of which are surveyed in a seminal paper by David Shurnick.[1] Others have developed methods of evaluating loss reserves.[2] "No single reserving method can possibly produce the best estimates in all situations. Every reserving method is based on certain underlying assumptions which may or may not be satisfied in a given situation.[3] Thus, a method that is appropriate for one line of business may not be appropriate for another.

3. The Relationship of Reserves to Premium and Risk

Reserves should be and generally are directly related to the potential liability for which they are designed:

- The unearned premium reserve is directly related to the risk (potential return of premium), and premium is accordingly the calculation base;

- Loss and loss expense case reserves for reported, outstanding claims are based upon claims reported, adjusted for potential loss development based upon historic claim experience and thus directly related to risk;

- IBNR reserves may be based upon trends in IBNR, case reserves, or premium in force -- the former bases are directly related to risk (losses) and independent of premium, while the third calculation base is directly related to premium and only indirectly related to risk; and

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[1] D. Shurnick, "A Survey of Loss Reserving Methods," Proceedings of the Casualty Actuarial Society, LX, 1973, pp. 16-59.

[2] W.H. Fisher and E.P. Lester, "Loss Reserve Testing in a Changing Environment," Proceedings of the Casualty Actuarial Society, LXII, 1975, pp. 154-172; R. Ferguson, "Actuarial Note on Loss Rating," Proceedings of the Casualty Actuarial Society, LXV, 1978, pp. 50-56; R. Salzmann, "How Adequate are Loss and Loss Expense Liabilities?" Proceedings of the Casualty Actuarial Society, LIX, 1972, pp. 1-15; and J.R. Berquist and R.E. Sherman, "Loss Reserve Adequacy Testing: A Comprehensive, Systematic Approach," Proceedings of the Casualty Actuarial Society, LXIV, 1977, pp. 123-185.

[3] Ibid, p. 124.

Another notable feature of the various reserves is the experience period on which the reserve calculation is based. The unearned premium reserve covers a potential risk that endures for the policy term. Loss reserves are based upon five or more years of experience data, depending upon the line of business and the length of the tail on the development curve.

ALTERNATIVE RESERVING PHILOSOPHIES

1. The Actuary

The actuary's philosophy toward reserves is embodied in statutory insurance accounting and actuarial reserving procedures. Conservatism underlies all reserve calculations and procedures established by the actuary. Income recognition is deferred, and losses are recognized as incurred. To the maximum extent, reserves are calculated objectively on the basis of statistically credible experience related to the level of loss exposure, not to the rate charged for the insurance.

Statutory accounting principles (SAP) are based upon liquidation values rather than the insurance company's position as a going concern. Thus, the actuary attempts to establish reserves that are sufficient to liquidate known and potential liabilities. The purpose in establishing a reserve is to provide assurance that adequate funds will be available to cover these potential liabilities.

Establishing reserves is far from a precise science. For some lines of business, the actuary and claims adjuster can develop consistent and accurate estimates; in many other lines, however, losses vary substantially from year to year and more uncertainty exists about the level of expected losses. Thus, reserving is still regarded as a mixture of art and science by actuaries.[4]

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[4] W.E. Bailey, "Establishing Reserves -- Science or Art?" National Underwriter, July 25, 1980.

2. The Accountant

The philosophy of the accounting profession has been synthesized in Generally Accepted Accounting Principles (GAAP) and in the opinions of the Financial Accounting Standards Board (FASB) and its predecessor's opinions. The insurance industry's statutory accounting philosophy evolved through the application of actuarial principles and with full recognition of the insurer's fiduciary responsibility to its policyholders. Insurance accounting has been a stepchild of the accounting profession; the American Institute of Certified Public Accountants (AICPA) did not develop guidelines for fire and casualty companies and stock life companies until the late 1960s and 1970s.[5] The insurance industry "Audit Guides" provide instructions for auditing statutory accounts as well as for transforming insurance company financial statements from a statutory basis to a GAAP basis.

The accountant's GAAP view of the world is predicated largely upon experience with other (non-insurance) industries. The GAAP adjustments to reserves are of the utmost importance to an insurer, however. These adjustments are based upon concepts developed in other industries related to the proper matching of revenues and expenses. Thus, under GAAP the statutory values of earnings, equity and assets are increased to reflect the prepayment of acquisition expenses. In addition, loss reserves are allowed only for losses that occurred with reasonable certainty over the exposure period covered by the policy (i.e., contingency or catastrophy reserves cannot be charged against income), on the assumption that this reflects costs related to premium revenue. However, GAAP does not call for discounting of reserves (or any other item on the balance sheet) to reflect timing of cash flows.

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[5] Audits of Stock Life Insurance Companies, prepared by the Committee on Insurance Accounting and Auditing, American Institute of Certified Public Accountants, 1972; and Audits of Fire and Casualty Insurance Companies, prepared by the Committee on Insurance Accounting and Auditing, American Institute of Certified Public Accountants, 1979.

3. The Economist

The economist's view is broader than that of the actuary or the accountant, for he is primarily concerned with the utilization of capital within the economy for the production of goods and services to satisfy society's requirements. The economist views insurance companies as fulfilling a very special and necessary role in the economy. By allowing investors to transfer risk and uncertainty from their investments to an insurance company, the insurance mechanism facilitates economic activity. However, if the insured is uncertain about the insurance company's ability to pay claims when due, or if the availability of insurance service is limited, the insurance mechanism cannot perform its proper economic function and general welfare is thereby diminished.

To the economist, insurance reserves reflect a key portion of the capital necessary to enable an insurance company to offer the prospect of successfully accepting the risks and uncertainties transferred by policyholders to it. Inadequate reserves diminish the effectiveness with which the insurer can be viewed as relieving the insured of the risk of loss. To the economist, an insurance company cannot function properly unless its reserves are adequate not only to deal with day-to-day fluctuations in loss experience but, where a catastrophic risk element is present, to offer reasonable promise of meeting losses under those catastrophic conditions.

In addition to functioning as the key element that supports the economic service of an insurance company (risk transfer), reserves together with surplus constitute the capital employed by the insurance undertaking. As such, the economist is concerned that this capital earn a rate of return commensurate with the business and financial risk to which it is exposed. The calculation of the net income earned or the capital employed is affected by the establishment of reserves of all kinds. The levels of reserves affect the size of the capital base necessary for conducting insurance operations. Since contributions to reserves for future liabilities are properly regarded as charges against income, they reduce the company's net income and rate of return.

RELATIONSHIP OF RESERVES TO SOLVENCY AND SOLIDITY

Solvency implies the ability of an insurer to meet obligations for claim payments and other costs when due. At a minimum, an insurer's assets must exceed the value of its liabilities to be considered technically solvent. Solidity is a broader concept and indicates the ability of a company to continue normal business operations (i.e., to continue to offer new and renewal policies) and remain solvent over some period of time. The duration of the time period or conditions that are used to measure solidity depend on the characteristics of the insurance product.

Insurance reserves are but one of several factors that influence the solidity and solvency of insurance companies. Capitalization, rate adequacy, and other factors, such as the nature and quality of investments, are also related directly or indirectly to solvency. If premium rates and investment income do not cover losses and other expenses, the company must fund the latter from surplus and other sources. Under these conditions, capital will leave the business for lack of adequate return. If reserves are inadequate, those obligations must be funded from surplus. If surplus is inadequate to absorb fluctuations in losses and assets that might occur over the long term, then the firm's solidity is in doubt.

WHY AREN'T PROPERTY-CASUALTY RESERVES DISCOUNTED?

P/C companies generally do not discount loss and loss expense reserves. However, in some lines and in some types of insurance facilities, some discounting of reserves takes place.

In most states, reserves for workers compensation permanent disability claim settlements are discounted by a statutory rate. The rate specified is conservative (two to five percent) and is applied to the portion of the settlement which reflects the weekly or periodic payments to the disabled claimant. The rationale for discounting here is that these claims are similar to disability income claims in that a specified sum will be paid for a specified period of time. The reserve amount is established based on mortality tables and then discounted. The rate is lower than the insured yield on investment because the reserves will be adequate to pay these claims considering uncertainty as to life expectancy.

Medical malpractice reserves also are discounted by some insurers. Specifically, state joint underwriting authorities and other state-created insurance programs operate with discounted reserves. In several states, these facilities have negative surplus even after discounting, meaning that the discounted reserves are greater than assets. Commercial carriers are not allowed to operate in this fashion. They would be insolvent under these circumstances and would be placed in rehabilitation under the supervision of the insurance commissioner.

CASH BASIS STATE INSURANCE PROGRAMS

The state insurance programs operating on a "cash basis" or without adequate reserves, even on a discounted basis have fallen into the same trap as the Federal Social Security Program. Joint Underwriting Associations (JUA) or other plans were established when the commercial market would no longer write some of the population (e.g., automobile insurance for bad drivers) or most of the population (e.g., medical malpractice insurance) at rates allowed by the insurance department. The JUA's are established with no capital, no state funding in guarantee, usually with an assessment provision to make up for rate inadequacies. They are often mandated to pay for themselves -- i.e., revenue must equal assets.

As a practical matter, insurance commissioners have been reluctant to raise premiums to the levels necessary to pay for incurred losses and expenses.[6] The first rationalization may be to discount reserves, such as has been the case with medical malpractice JUAs. The second rationalization is to go one step further to a "cash flow" basis of operation. Current insureds are not paying the economic cost of their insurance coverage, but the hope is that by some magic future premiums can be used to offset today's losses.

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[6] See "N.J. JUA Wants $150 Surcharge; Dept. Objects," National Underwriter, Property-Casualty Ed., July 15, 1985, p. 27.

These "cash basis" plans are becoming less and less insurance and more like a transfer payment financed through a tax (akin to Social Security). "Cash basis" would, in fact, require current policyholders to pay for the losses generated by past policyholders.

Further, the reliability of the insurance contract is in doubt. Insurance can only reduce uncertainty if the policyholder believes the insurer will be able to pay losses when they come due. Policyholders will place less reliability in cash-based insurance programs. Such programs would have no or grossly inadequate reserves and would be insolvent (have negative capital). The ability of the insurers to pay claims would be contingent upon their:

- ability to raise premium rates in the future sufficient to cover the losses; and
- ability to retain a sufficient number of policyholders willing to pay the rates.

In Massachusetts, the medical malpractice JUA is operating with a reserve inadequacy of about $100 million, after discounting reserves at 11 percent. The state insurance commissioner has not allowed rates to increase to adequate levels. Even though premium rates are below cost and below levels in other states, one class of physicians with lower than average risk (psychiatrists) is leaving the pool. The cost for the unfunded losses will fall on the physicians remaining, who may not be able to absorb such a large deferred expense, and may ultimately fall back on claimants unable to recover for economic loss.

OTHER COMPETITIVE IMPACTS

Medical malpractice and other liability lines, such as environmental impairment liability insurance, are susceptible to another adverse impact as a consequence of the Administration tax proposal. Medical malpractice insurance is characterized by chronic rate inadequacy, caused by the inability of insurance companies to foresee the "social inflation" in claim settlements due to the tendency of juries to award higher and higher sums in malpractice settlements. The response to date to the ever-increasing premium rates for malpractice insurance has been a shift to claims-made policies (which has reduced the length of the long payout tail), formation of physician-owned or sponsored companies, and, in some states, creation of state facilities to provide malpractice insurance. Workers compensation insurance, in some states, is only available from a state monopoly facility.

State insurance facilities have competitive advantages over commercial insurers:

- They do not pay U.S. income tax;
- They need not maintain adequate (or any) loss reserves; and
- They may operate without any capital mandated by the state.

The Treasury is already distressed by the amount of current tax revenue lost due to insurance placed in the existing state facilities. The magnitude of the price increased required by commercial insurers to cover the new taxes imposed by the Administration's plan on these lines of insurance favors public insurance over private insurance. The relative size of medical malpractice insurance to the physician's cost of doing business and the level of workers compensation premiums relative to a business's expenses result in a high level of concern at the state level today about rates in these lines. The magnitude of the price increase required by the commercial insurers for these lines under the

Administration proposal undoubtedly will result in the formation of additional state facilities. This in turn will reduce tax revenue. Furthermore, society may be worse off in terms of resource consumption or total societal cost because the incentives for loss prevention (workers compensation), efficiency, and proper pricing are reduced if not eliminated in a public program which prices its insurance without regard to total liabilities and costs. State insurance programs tend to become like the U.S. Social Security program, a premier example of a cash-based "insurance" system, which continually postpones the recognition of the costs associated with current liabilities.

Senator LONG. We do not have time this morning to explore adequately the problems that have been raised and discussed by the witnesses. We will have discussions at the staff level with you and your representatives and will try to help solve this problem.

Let me say to Mr. Lardner and Mr. Maisonpierre that I find it incredible to be hearing this kind of testimony by witnesses with their credentials at this stage of the game. I should think that we will see a change of position by Treasury before the bill gets to the Senate. To hear this kind of testimony when the bill has been out there this long is something that I find almost unbelievable, especially in view of the fact that this administration is respected as one that appears to be—or at least contends that it is—business oriented. I assume that we will work this thing out.

Thank you very much for your testimony.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you very much. It's like old times. [Laughter.]

Senator HEINZ. Gentlemen, I want to apologize for not being here to hear your testimony. We had a total Republican turnout at the White House this morning.

Let me ask, did any of you discuss the Ways and Means Committee staff proposal?

Mr. ANDERSON. No, sir.

Senator HEINZ. You did not. I think, as Senator Long has probably indicated, I understood his reference—he has a dim view of the QRA proposal. I suspect he is right in, that the White House will wake up and have a dim view of it shortly; particularly since I don't sense that there is much support for it any place.

But I am interested in your views on the Ways and Means Committee proposal, and I would solicit comments from Mr. Maisonpierre.

Mr. MAISONPIERRE. Senator Heinz, our organization looks at the Ways and Means staff proposal as perhaps even more onerous than QRA. It's QRA plus. What it provides really is it puts us on a cash base——

Senator HEINZ. It should be pointed out that in spite of the fact that the administration is Republican, there is a rumor going around that the Ways and Means Committee is Democratic. [Laughter.]

I just felt that we should have an even-handed approach.

Senator LONG. Right, but watch out for these bipartisan deals. [Laughter.]

Sometimes you get the worst of both worlds.

Senator HEINZ. Senator Long has made a very good point.

Mr. MAISONPIERRE. I'm afraid, Senator Heinz, that we are getting it from both sides, obviously. But the Ways and Means staff would also put us on a cash base as QRA would. But, in addition, we would be getting some additional wrinkles in the staff proposal.

What is particularly bothering to us is being placed on a cash base. Let me give you a very specific example. I don't think that there is a recognition out in the world and even perhaps within the industry that we have certain exposures that are, in fact, on a cash base. Let me give you two examples.

If Gloria had come in about 20 miles closer to shore and had done the damage which we feared, the industry would have sustained literally billions of dollars in losses for which we have absolutely no reserve set up. We are on a cash base for our entire catastrophe exposure. We are on a cash base with respect to earthquake losses. Had the Mexican disaster occurred a few hundred miles north, I would guarantee you that there would have been some serious problems in the industry; that many of my members, in fact, would have become insolvent.

In fact, Senator Heinz, just to show you how seriously we regard being placed on a cash base, we had put together before the Mexico City disaster—we put together a proposal to bring to Congress to allow some form of a Federal mechanism to assist in case of the type of catastrophe similar to what Mexico City endured.

Now let me put your mind at ease. This does not——

Senator HEINZ. Mr. Maisonpierre, let me ask you this: We need to, for the record, identify what parts of the Ways and Means Committee proposal are bad and what are good. I gather the part that puts you on a cash base is bad. Is there any good in the Ways and Means Committee proposal? Is there anything that you can accept? Nobody likes having to pay more taxes. I understand that. But are there other parts that are tolerable?

Mr. MAISONPIERRE. Senator Heinz, there is one part of the proposal which mirrors to some degree the proposal which the industry has made to Ways and Means. We believe that the first part of the proposal, dealing with revenue offset, should be expanded to the level that is proposed by the industry, and that it should be a complete substitute for the Ways and Means proposal. We don't think that we can live with the Ways and Means proposal as structured. We think that the first part of the proposal, as expanded, is quite similar to that which the industry has suggested and will raise in dollars the same amount over the next 5 years which QRA will raise.

Senator HEINZ. I understand that. Is there anybody else who would care to add to that?

Mr. ANDERSON. Bill Anderson from GAO, sir. Dr. Gandhi has been working with Ways and Means on some of their proposals and is enlightened more on GAO's views and various aspects of it. He will speak to it.

Before we do that, though, I think it's important for me to address GAO's own view that one of the reasons we put these exhibits in our testimony and before you here today was to show that over time the property/casualty insurance company has been relatively profitable. In fact, the return on investment compares favorably with that of industry generally. I noticed that over the last year, the value of their stocks has increased about 40 percent as compared, say, to an increase of 20 percent for stocks generally.

So that should not be a consideration in deciding, in our view, what is right with respect to taxation of the industry.

So let me turn it over to Dr. Gandhi for comments on the Ways and Means proposal.

Dr. **Gandhi**. As Mr. Anderson pointed out, the important thing that we want to keep in mind is that, industry already has accumulated around $7 billion in net operating loss carryovers. I think that this huge amount has to be kept in mind in terms of how much tax can indeed be received from the industry, no matter what proposal is drawn up.

So at this moment we are trying to develop some estimates, revenue estimates, as to whether or not the Ways and Means proposal would indeed generate any money. We do not have any specific comment in light of these seven elements that are put together in the Ways and Means proposal. We are at this moment studying that.

Mr. **Anderson**. We will provide—we will be working with your staff sir, and giving them our views on the provisions.

Senator **Heinz**. My time has expired.

Senator **Long**. There is one area that I was not planning to ask about but I have been impressed sufficiently by what has been said that I feel like exploring it.

I am thinking about the kind of risk for which you are liable but for which you might not be able to pay. For example, all of our flood control predictions on the Mississippi River are based on experience, and we think that the levees are high enough. That is a great flood control system. It involves more than $1 billion of investment in Louisiana alone. I would think that if you had to replace it, it probably would cost you $5 or $6 billion.

But the system is built on the assumption that we are not going to experience a flood that would exceed 10 percent of any flood on record. The fact that we are looking at a record does not mean that you cannot have more rain than in the past, even enough where you might have 30 percent more than anything on record.

For example, along the Red River from Shreveport down to the Chafelie River, which is about 150 miles, the water topped the levees in all places at the same time. Such a thing is possible even though it has not happened before.

Now I would like either of you to give your thoughts as to the kind of risks for which you are liable which could exceed anything you would be in a position to pay.

Mr. **Lardner**. Mr. Chairman, you question is well put, and your example is appealing to me because I live up river from you in Illinois. And as we keep squeezing the Mississippi tighter and tighter, it keeps going higher and higher.

The problem we have in the property/casualty business is we rely on a general assumption that the past is predictive of the future. And as your example points out, that's not necessarily true. Furthermore, it's very specifically not true in the so-called civil justice system. We are seeing judgments come down which are multimillion dollars, totally out of sync with the past, totally unanticipated by our rate structure, totally unanticipated by our actuaries.

I think it's for that possibility of the future being different and more costly than the past that the statutory accounting system is attempting to protect the solvency of the companies the public is relying upon. And we think that certain tax proposals end up being an attack on the solvency represented by statutory accounting. And we think the very point that the future is different and far more costly than the past in a number of instances is an important consideration when we talk about how the industry is doing and how it might do tomorrow.

Senator LONG. There is one situation with which I am familiar. When the tidewater channel was built in New Orleans, no one told us about the potential danger of a hurricane moving up that channel. If it ever occurred to the advocates of the channel, I assume they didn't tell the Congress for fear that it would run up the cost and kill the cost-benefit ratio.

When Hurricane Betsy hit, that's just what happened. It came up and the channel surge of water pushed by the hurricane topped the levees. The levees were strong enough; everything that the State of Louisiana built held, and some of that was built under my father. Everything the Federal Government built held. But when the locally built levee was topped, it went.

It only takes one opening in a levee and you might as well forget about it. Everything was under water, and we lost lives.

That to me, illustrates how the damage or the liability could be a great deal more than any one anticipated. It was not the companies' fault, but they had to pay.

We had a similar situation when Hurricane Audrey hit Louisiana in the area of Cameron. They had been through hurricanes in that area before and everyone thought they could take a hurricane. There was one difference. Never before had a hurricane pushed a tidal wave in front of it. The tidal wave plus the hurricane wiped out everybody except a few who managed to get in an old courthouse.

I want Mr. Maisonpierre to comment about risks which were not anticipated. What happens when a combination of events makes it such that you might not be able to pay?

Mr. MAISONPIERRE. Mr. Chairman, this is the reason that the insurance regulators insist that the companies have a certain relationship between the surplus which they have their equity, and the premium, which they write. The surplus is really the cushion which the companies have to pay these unanticipated losses.

True, we do have studies as to the probable maximum loss resulting from certain exposures here and there, but as you say, it is very difficult to estimate what the losses will be. Let me give you an example.

Probably the worst earthquake that we had in this country occurred about 1816 in the Missouri area around St. Louis. The losses which were generated as a result of that earthquake——

Senator LONG. Did you say an earthquake?

Mr. MAISONPIERRE. About 1816. That's right.

Senator LONG. Where?

Mr. MAISONPIERRE. Around the St. Louis area in 1816.

The losses generated then were minimum because the affected area was nothing but prairie. Now if we had the same type of earthquake today, the Government agencies tell us, and we agree with them, the losses probably would be about $50 billion. What are we going to use for experience? The fact that the 1816 earthquake generated no loss? If that earthquake occurs—and you can rest assured that it will occur—we know the losses will be in the neighborhood of $50 billion, and the industry would be unable to pay for such losses. We do need to reserve claims. This is needed to insure the stability of the industry, very frankly, to take care of these situations as well as situations such as the asbestos situation. We never anticipated having to pay any losses on asbestos. We collected premiums for exposures which were totally unknown to us. And now we are paying literally billions of dollars in asbestos law suits, and there were no reserves set aside for those losses.

Senator LONG. Thank you very much.

Dr. GANDHI. May I make a comment, sir?

Senator LONG. Yes, sir, Dr. Gandhi.

Dr. GANDHI. I also appreciate living on the banks of the Mississippi because I lived in your lovely city of Baton Rouge for 3½ years.

Senator LONG. Well, thank the Lord that we do have some land in Baton Rouge that is above the flood plain.

Dr. GANDHI. Yes, sir. [Laughter.]

Senator LONG. Not all of it, but some.

Dr. GANDHI. I appreciate that, sir.

What I do want to point out, however, are two things. One, that the insurance industry deals in the future. That's their business. And, second, that in spite of all the losses they may have suffered, they still were able to generate a positive amount of cash every year. Even in 1984, which was the worst underwriting experience that they have suffered, they had around $12 billion of net cash flow after meeting all the claims and expenses. So we want to keep that in mind.

And I think a longer perspective that Mr. Anderson spoke so well about should be kept in mind. And that is over those 10 years, ending in 1984, industry had net gain of around $75 billion. And the industry had negative income taxes of around $125 million over those 10 years. So we want to keep that in mind that in general the industry does have enough cash to meet the claims, no matter how large the losses. And that they have been able to carry on all these years very well.

Senator LONG. Senator Bentsen.

Senator BENTSEN. Mr. Anderson, would you address a remark that was made by Mr. Maisonpierre? Let me ask you about his concern about driving the U.S. industry business overseas, insurance business. We get those remarks from time to time and then it's difficult to evaluate it. But I would like for you to examine it. I'd like for you to—could I get a green light to start with? [Laughter.]

I'm concerned about the trade deficit, and trying to keep some business at home. Give me your response to this statement of the gentleman in the reinsurance business that it's going to send the business overseas. Tell me about the tax system that we run into in Zurich, for example; in Germany, for example, where you have some great reinsurance companies. Do they have a better tax break than ours do? What happens if the administration or your proposal is adopted?

Mr. **Anderson**. Yes. Let me back into that, if I may, sir. And I'm going to look to Dr. Gandhi for help.

Senator **Bentsen**. Not too far now. I don't have a lot of time.

Mr. **Anderson**. Not too far. I have one paragraph that was in our original report to this committee that spoke—well, there are several paragraphs. There is one I would like to read. It spoke to foreign competition generally. Obviously, it is a concern. And it's a concern—it was a concern before Ways and Means when we testified, and we had a number of questions. And it's also of concern here today as well.

Let me read this and then I will come back to another comment in that regard: "With respect to foreign competition, one expert"—and we spoke to many. And I don't say that this is necessarily the last word—"told us that it is a relatively small part of the U.S. insurance scheme. And most foreign competitors have U.S. subsidiaries or branches and are subject to U.S. tax. Any improvement in the competitiveness of foreign companies will only benefit those foreign companies that have no U.S. operations and can write reinsurance on U.S. risk." Your point. "However, the adoption of section 845 in the 1984 Tax Reform Act, which permits the IRS to disregard reinsurance transactions that reduce taxes, should effectively inhibit such transactions. Also, we have been told by experts that relatively few such companies exist. They constitute a small portion of the market and tax is not likely to be of significant consideration in pricing such reinsurance."

Now before I go over to Dr. Gandhi, there is one other point that I feel is important to make.

Senator **Bentsen**. I want to have Mr. Maisonpierre respond.

Mr. **Anderson**. All right, fine, sir. The one comment I did want to make in addition was that I don't need to tell the members of this committee that there is a large part of the American economy, industrial and other parts of the economy, that are having problems with overseas competition, thanks to the free entry that we have into this market of ours.

I just don't know where you stop and start with respect to—considering changes in the Tax Code and their ability on one industry or another's ability to combat overseas competition. It seems like a dangerous new direction to go in. But that's one——

Senator **Bentsen**. Now let me have this gentleman address that because I saw him shaking his head. He is obviously in disagreement with you.

Mr. **Maisonpierre**. Senator Bentsen, in the first place, with respect to reinsurance, reinsurance is an international trade.

Senator **Bentsen**. It sure is.

Mr. MAISONPIERRE. And it may well be that although the reinsurance premiums generated from this country represents only 10 percent of the entire insurance premiums generated in this country, insofar as the reinsurers are concerned, it's 100 percent of their business. So that to the extent that there are alien companies, foreign companies that can compete better than we can because of the Tax Code, it will put us out of business.

Senator BENTSEN. Thank you very much.

Now let me ask you the next question. Mr. Lardner says that in effect the administration's proposal would tax investment income twice. How do you respond to that?

Mr. LARDNER. I believe that to be true under the QRA, Senator. The investment income is taxed——

Senator BENTSEN. Mr. Lardner, I really wanted Mr. Anderson to answer this.

Mr. LARDNER. Oh, I'm sorry.

Senator BENTSEN. I'm sorry. I didn't make it clear.

Mr. ANDERSON. You said Mr. Lardner made the point that under the QRA that the investment income is taxed twice, and what's our reaction to that.

Senator BENTSEN. That's right. Mr. Gandhi.

Dr. GANDHI. Senator, I think there are some cases in which it is possible that it would be taxed twice.

Senator BENTSEN. You think what?

Dr. GANDHI. It would be taxed twice. There are some cases in which one could see that. However, that's one reason why we believe that the GAO method would be an appropriate method of discounting reserves because that is a pure and simple discounting. All we want them to do is to recognize time value of money.

Mr. ANDERSON. You weren't here, sir, when we made the point earlier that there are some provisions of the administration's QRA proposal that GAO has difficulty with and has gone on record.

Senator BENTSEN. Well, I went over some of it ahead of time and I noticed those areas.

All right, thank you very much.

The CHAIRMAN. Senator Matsunaga.

Senator MATSUNAGA. Thank you, Mr. Chairman.

I have one question for Mr. Anderson. Do you perceive a substantial revenue loss as a consequence of property/casualty insurers being included in a consolidated return with life insurers and conglomerates?

Mr. ANDERSON. We point out in our statement, sir, that we looked at the largest property/casualty companies who were part of consolidated returns. And we found that the tax advantages that property/casualty companies have, allowed the parents of those organizations to realize $715 million in tax advantages. In other words, they were able to use the tax loss as opposed to the economic gain that the property/casualty subsidiary had to offset operating income of their own.

Senator MATSUNAGA. In a competitive business such as they are involved in, would you say that that $715 million may be something which may have kept them in business in America?

Mr. ANDERSON. You mean the parent organization, sir? See, the property/casualties, we did an analysis of them and we couldn't find the performance differed significantly at all really between those that had parents, nonproperty/casualty or a nonlife insurance parent, and those that were stand-alones, so to speak. It really didn't seem to affect their ability to compete within the industry. In fact, surprisingly enough, we found some loss of market on the part of the property/casualties that were subsidiaries of other parents, like Sears, for example.

Senator **Matsunaga**. How many companies share the $715 million?

Mr. **Anderson**. Six, sir.

Senator **Matsunaga**. Only six companies?

Mr. **Anderson**. Yes; but they were six of the very largest.

Senator **Matsunaga**. No further questions, Mr. Chairman.

The **Chairman**. Senator Chafee.

Senator **Chafee**. Gentlemen, I have no questions. I apologize for being late. I was at the White House this morning. Thank you very much.

Mr. **Anderson**. Thank you.

Mr. **Lardner**. Thank you, sir.

Mr. **Maisonpierre**. Thank you, sir.

The **Chairman**. Now if we could have a panel of James Osborne, Bradford Mitchell, and Franklin Nutter.

I take personal pleasure in welcoming Jim Osborne to this panel this morning. He's a man I have known, for what, one-quarter of a century, Jim.

Mr. **Osborne**. Just about, Mr. Chairman.

The **Chairman**. Yes; he's an old, old friend, acquaintance of mine, and 2 weeks ago was elected as the incoming president of the National Association of Mutual Insurance Co. Congratulations.

Mr. **Osborne**. Thank you very much, Mr. Chairman.

The **Chairman**. Unless you gentlemen have any preference or worked out something different, we will simply take you in the order that you appear on the witness list. And your entire statements will be in the record, and we would appreciate it if you could abbreviate your comments to 5 minutes.

Senator **Heinz**. Mr. Chairman, I am delighted to welcome a witness from my home State of Pennsylvania; Brad Mitchell, from Harleysville who is the chairman of the National Association of Independent Insurers.

Mr. **Mitchell**. Thank you, Senator.

The **Chairman**. Go right ahead, Jim.

STATEMENT OF JAMES L. OSBORNE, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, OREGON MUTUAL INSURANCE CO., McMINNVILLE, OR; AND VICE CHAIRMAN, NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. **Osborne**. Thank you for those kind remarks, Mr. Chairman. It's a pleasure to be here this morning. For the record, I am Jim Osborne, executive officer of the Oregon Mutual Insurance Co. and chairman-elect of the National Association of Mutual Insurance Co.

Oregon Mutual was founded in 1894 and operates in the West. We write business in Oregon, Washington, Idaho, and California and are representative of the average medium-size regional mutual insurance company.

The National Association of Mutual Insurance Co., or NAMIC, was founded in 1895 and is the Nation's largest insurance company trade association, with membership of 1,260 companies. The size of these companies varies from the very large to the very small, making our association unique.

Approximately 800 of these companies are farm mutuals that write $1 million or less of annual fire and liability premium. They are organized to meet specific needs of local consumers, not because of the profit motive, but rather a desire to share resources to protect against losses. They are grassroots oriented. And their board of directors consists of local farmers, businessmen, and ordinary citizens. In many areas of the country, they are the only available market for farm and rural dwelling coverage. The primary coverage they write are personal lines, which is protection for farms, homes, and automobiles. I could tell you many, many stories that illustrate the closeness that many people feel toward their mutual companies.

And I would just like to say that in our home State, during the catastrophe of 1962, Mr. Chairman, if you will remember, I was doing some loss adjusting down in the Cottage Grove area and an 86-year-old lady, a policyholder of ours for 50 years, and I adjusted the loss on her house. And I said now let's take a look at the barn, and she said, Mr. Osborne, you have been most generous. She says, one thing I want you to remember, young man, this is our company and we have to protect it.

But what I'm saying is that represents the closeness that I want to emphasize. And it's a feeling. It is a way of life. The business of most of these companies is conducted in local areas. They have large exposures in small geographical areas resulting in heavy dependence on reinsurance.

Our written statement covers four issues, and I will only comment on two—the small company provisions and the protection against loss or PAL account.

However, we are equally concerned about the other two issues, but now I would like to talk about the small company provision. Now Congress long ago recognized the unfair competition between stock and mutual companies. To maintain fairness, small mutuals were taxed differently. All mutuals were exempted from taxes in 1924. In 1942, the exemption was limited to companies having $75,000 in gross receipts.

This was established primarily for the purpose of raising additional revenue during the war years. In the 1972 Revenue Act, Congress increased the gross receipts limitation, determining tax-exempt status to $150,000. Additionally, companies with gross receipts of from $150,000 to $500,000 were taxed solely on investment income.

These exemptions have not been increased since 1962 and, consequently, have not kept pace with the rate of inflation. These provisions are not an incentive, but a recognition of the need for the availability of insurance.

Let's look at what the elimination of this deduction would do. A survey of 466 of our member companies disclosed that the proposal would increase their tax burden 125.6 percent and primarily in the farm areas.

Now I would like to talk briefly about the protection against loss account. Congress recognized the necessity for equality between stock and mutual companies and created the tax deferral system. Mutual companies can defer 1 percent of losses incurred and 25 percent of underwriting gains for a period of 5 years. This resulted in a more level playing field since mutual companies do not have access to capital markets to cover catastrophes or requirements for additional capital.

The **Chairman**. Jim, I've got to ask you to conclude.

Mr. **Osborne**. I was just getting right there.

And I would like to reemphasize that this is a deferral. The protection against loss account helps build surplus at a very, very critical time.

And if you have any questions, Mr. Chairman, members of the committee, I would be happy to respond.

Thank you.

The **Chairman**. Thank you.

[The prepared written statement of Mr. Osborne follows:]

HEARINGS BEFORE THE COMMITTEE ON FINANCE,

U.S. SENATE OCTOBER 1, 1985

Statement on Behalf of the National Association of
Mutual Insurance Companies (NAMIC)

Prepared by Michael J. Cuddy,
Michael G. Heitz and
Gerald I. Lenrow
of Coopers & Lybrand

Testimony will be presented by James L. Osborne
of Oregon Mutual Insurance Company

INTRODUCTION:

The National Association of Mutual Insurance Companies (NAMIC) is made up of over 1,230 member companies, the vast majority of which write farm property and casualty risks. Nearly 800 of the NAMIC members are property insurance companies only and are designated as farm, county or township mutuals. They were organized during the 1800's to address a market void and meet the insurance needs of rural America.

They are spread throughout forty-one states and, being mutual in nature, represent a forerunner to modern consumerism. Among the remaining membership, many of the companies are large and write property and liability coverages of all types. They range in size from the very largest to moderate sized companies.

The Association, which was founded in 1895, is headquartered in Indianapolis, Indiana. Its President is Harold W. Walters and its Legislative Vice President is Dale D. Skupa. Washington Counsel is David A. Hartquist of Collier, Shannon, Rill and Scott, 1055 Thomas Jefferson Street, N.W. Washington, D.C. Testimony will be presented by James L. Osborne of Oregon Mutual Insurance Company.

In a Press Release dated August 9, 1985, the Honorable Bob Packwood, Chairman, Committee on Finance, U.S. Finance, announced the continuation of public hearings on President Reagan's proposal on comprehensive tax reform, and, in so doing, scheduled hearings for the insurance industry on October, 1, 1985.

Our statement discusses in detail two of the proposals that the Committee will address and to which we will submit oral testimony at the October 1, 1985 hearings:

1. Repeal of Mutual Property and Liability Insurance Company Protection Against Loss Account.

2. Repeal of Special Tax Exemption, Rate Reductions, and Deductions of Small Mutual Property and Liability Insurance Companies.

In light of the seriousness of the other two issues that will be addressed by other trade associations, we also feel compelled to comment briefly as to our objections regarding the proposals concerning the Qualified Reserve Account and limitation on the deduction for policyholder dividends.

PROTECTION AGAINST LOSS ACCOUNT

Current Law

The primary difference between the taxation of stock property and liability companies and mutual property and liability companies is the Protection Against Loss ("PAL") account afforded mutual companies under Code Section 824. This provision was introduced by the Revenue Act of 1962. Prior to 1963, mutuals were taxed under a special formula which did not take into account underwriting income or loss. As a consequence of the 1962 amendments mutuals became subject to tax on underwriting income. In making this change, Congress recognized the special characteristics of mutuals and the PAL account is evidence of this recognition.

Mutuals are owned by their policyholders rather than stockholders. As a result of their structure mutuals lack the ability to raise capital. For these reasons, Congress in 1962 provided a special tax deferral account for mutuals, the PAL account.

Statements prepared by both the Senate Finance Committee and the House Ways and Means Committee on the 1962 Revenue Act indicate the intent behind the PAL account.

Congress recognized that:

"While a stock company can pay extraordinary losses not only out of its accumulated profits, but also out of its paid in capital, a mutual insurance company can pay extraordinary losses only out of retained underwriting income. As a result, a mutual ordinarily retains a portion of its underwriting income each year for this purpose; the remainder is paid to its policyholders as policy dividends. This accumulated underwriting income constitutes its reserve out of which insurance losses can be paid and the existence of such reserves is an important protection to the mutual policyholders.

Under the law up to this time, no income taxes have been paid on this retained underwriting income, except (since 1941) to the extent the excess of the alternative 1-percent tax over the tax on investment income in effect taxed part (all, or more than all) of the underwriting income. Similarly, underwriting losses may not reduce the tax on investment income. Under the President's proposal, underwriting gains would have been fully taxed as realized. Under the provisions of this bill, however, these mutual fire and casualty companies will be permitted to set aside a portion of each year's underwriting gains in a special account for protection against losses. This amount will be available to meet certain losses for 5 years, after which most of any remaining portion will be included in taxable income of the sixth year. A small portion, however, will still be retained in the special account to take care of extraordinary losses. Eventually, these companies will pay tax on their total income, but the tax deferral formula of the bill gives

> recognition to the mutuals' lack of access to the capital market for funds with which to pay losses. Under the bill underwriting losses, other than losses created by the special protection against loss deduction, will reduce the tax on investment income." (1962 Senate Finance Committee Report, page 55.)

Prior to 1962 mutuals were not subject to tax on their underwriting income. While a portion of this income was paid out as a policyholder dividend, the remainder was to provide for capacity and extraordinary losses.

The 1962 Act imposed a tax on ordinary mutual's underwriting profit. Thus, the remainder to provide for capacity and underwriting losses would be reduced by the applicable federal tax rate. In order to assure the continuing protection of policyholders Congress devised the PAL account. In devising the PAL account Congress attempted to put mutuals on a somewhat equal footing with stock companies which can "pay extraordinary losses not only out of its accumulated profits but also out of its paid-in-capital." Congress recognized that if mutuals did not have an additional source out of which losses could be paid they would be competitively disadvantaged. This is because a greater amount of reserve would have to be retained by the mutuals, and therefore, either higher rates would have to be charged or smaller policyholders dividends paid.

There are three allowable additions to the PAL account which represent deductions for the current year. These three additions are amounts equal to: (1) one percent of losses incurred; (2) 25 percent of underwriting gain; (3) a further percentage of underwriting gain, to the extent the percentage of premiums for concentrated windstorm and similar risks during the year exceeds 40 percent of all premiums.

At the same time, the Code sets forth five separate provisions for making annual subtractions from the PAL account which become inclusions in taxable income. They are:

1. The excess of the current year's PAL account additions over the current year's underwriting gain.

2. The current year's loss calculated as the excess of the underwriting and investment loss over the underwriting and investment income.

3. The amount of unused loss carryover that is carried from another year to the current year.

4. The amounts recorded in the PAL account reflecting additions from the fifth preceding year that have not been absorbed by losses or

otherwise taken into taxable income. However, one-half of the fifth preceding year's addition of 25 percent of underwriting gain may remain deferred until absorbed by losses, under this provision.

5. The balance in the PAL account at the end of the year is reduced to the greater of 10 percent of the net earned premiums, less dividends to policyholders, or the prior year's closing balance in the PAL account.

All subtractions are computed after the company has made its additions for the current year. Subtractions from the PAL account will never exceed the balance in the account as there cannot be a negative PAL account balance. Before a mutual can have an unused loss deduction for the year, its entire balance in the PAL account must be absorbed, or restored to income. Subtractions under (1), (2), and (3) above are computed on a first-in, first-out basis for amounts added during the preceding five years, and then subtracted from remaining additions of years earlier than the five immediately preceding years.

Proposal

The President's Proposal suggests that the continuation of the allowance of a deduction to mutual property and liability insurers of additions to PAL accounts would be unfair, since the deduction is unnecessary and is in fact unrelated to the measurement of economic income.

The Proposal continues by stating that the PAL account is nothing more than a bookkeeping entry made for tax purposes and a corresponding reserve is not required for statutory purposes and thus it in no way results in assisting financial solvency. The Proposal further states that the existence of the PAL account allows mutual companies to have an unfair competitive advantage as compared to stock companies, and notes that the calculation of the PAL account requires an arbitrary distinction between underwriting and investment income. This, the Proposal suggests, increases the complexity of the tax code. (This comment ignores the fact that this distinction is made for statutory accounting purposes and was in effect long before the PAL account was introduced.) The suggested effective date for discontinuance of the PAL account is December 31, 1985 specifying that any balance in the account would be included in income "no later than over a five-year period."

Analysis

Part of the rationale for the Proposal is the need to create a "level playing" field and to eliminate competitive advantages created solely by virtue of tax provisions. It is suggested that this Proposal, rather than avoid unfair competition, will in fact create it. More specifically, the reasons for the PAL account are as important today as in 1962. The rationale at that time was that mutuals needed the ability to defer portions of its taxable income to those years in which it would suffer large losses so as to have sufficient capital to meet its underwriting needs. This rationale continues to this day.

Among the reasons cited for this Proposal is the observation that the existence of the PAL account increases the possibility that "companies will undertake uneconomic transactions solely to minimize tax liability". This is specious reasoning. It should be noted that the tax benefits of a PAL account for a given transaction are far outweighed by the detriment suffered on undertaking an uneconomic transaction. It must be recognized that the PAL account deduction that would apply to an uneconomic transaction would be solely due to the account addition for 1% of losses incurred. Assuming the uneconomic transaction resulted in a loss, the 25% of underwriting gain, obviously, would not apply. Moreover, the uneconomic transaction if its loss was disproportionate could serve to reduce what otherwise had been accumulated in the PAL account. This would result since no balance may be maintained or added to the PAL account where there is an underwriting or unused loss deduction for the year. Consequently, an uneconomic transaction would have an adverse impact on the PAL account rather than a favorable one.

The PAL is of greatest importance to the small and medium sized mutuals operating in rural and less populated areas. These companies are often the only source of easily available insurance coverage in rural areas since the larger companies tend to write business in these areas on a non-recurring basis. In addition these smaller sized companies tend to be legally restricted to underwriting business in a small geographic area. Thus, there is less chance to spread the risk of loss from a catastrophic event which may occur and affect the geographic area.

A further point which must be made is that the PAL account allows mutuals to write additional business. This is because the account increases the company's surplus. Insurance companies writings generally are limited to a multiple of surplus (usually 3 to 1). Moreover, this additional capacity has the potential of increasing surplus so that although the PAL account is reduced during certain points in the underwriting cycle surplus will have been increased over a period of time through utilization of the PAL account. This additional capacity allows these companies to grow, with the result that more taxes may be paid over a period of time than would be the case if the companies did not have this ability to expand their underwriting.

Due to the present underwriting cycle many companies currently have eliminated any balance in their PAL account. In these cases the unused loss deduction available for carryback and carryover has been reduced for tax purposes by the amount previously accumulated in the PAL account. Thus, the Treasury has received the taxes which it would have received had there been no PAL account. The only difference the PAL account has made is that it has deferred the payment of the tax to a later year. The PAL has in this recent period of large underwriting losses proved to be a stabilizing influence on insurance markets because it has enabled companies to build their surplus to pay losses.

A joint survey conducted by three trade associations indicates that the PAL is very important and serves the purpose for which it was created. Approximately 75 percent of the members responding so indicated. Specifically, very few companies reported PAL account balances restricted by the statutory limitations, indicating that the intended surplus enhancement has been accomplished.

Conclusion

The need for the PAL account remains. As was the case in 1962, mutual companies do not have access to equity capital markets. If a mutual is deprived of the PAL account it will ultimately increase premiums or reduce policyholder dividends. If stocks and mutuals are taxed at the same level mutuals will be at a competitive disadvantage.

Moreover, as Congress recognized in 1962 the PAL account is a tax deferral and does not reduce the ultimate tax. "Eventually these companies will pay tax on their total income, but the deferral formula of the bill gives recognition to the mutuals' lack of access to the capital market for funds with which to pay losses." These same factors which warranted the creation of the PAL Account in 1962 still exist today. For these reasons, it is respectfully submitted that the PAL account should be retained.

SMALL COMPANY PROVISIONS

Current Law

The Code classifies mutuals into three categories dependent upon the amount of gross receipts. Mutuals whose gross receipts do not exceed $150,000 are tax-exempt. Companies whose gross receipts exceed $150,000 but do not exceed $500,000 are deemed small mutuals and may be taxed solely on investment income. A specific statutory provision excepts from this limited tax small mutuals that elect to be taxed on total income, or companies that have a balance in their PAL account. Companies whose gross receipts exceed $500,000 are deemed ordinary mutuals and are taxed on both investment and underwriting income.

For small mutuals with gross receipts of less than $250,000 the tax, which is on taxable investment income, will be reduced to an amount which is proportional to the gross receipts over $150,000 divided by $100,000. This benefit is on a sliding scale that produces smaller reductions as gross receipts approach $250,000.

A deduction is also provided ordinary mutuals and small mutuals electing to be taxed as ordinary mutuals. The maximum deduction allowed under this provision is $6,000 for companies whose gross receipts other than capital gains do not exceed $500,000. For companies whose gross receipts are in excess of

$500,000, the deduction is one percent of the difference between $1,100,000 and the amount over $500,000. The deduction is not allowed to exceed the company's underwriting income for the year before computation of PAL account provisions and the unused loss carryover.

Proposal

This proposal recommends that the exemption of those companies with gross receipts of less than $150,000 and the reduced tax rate permitted certain companies with low taxable income and the special deduction of $6,000 allowed those companies with taxable income of less than $1,100,000 - all be discontinued.

The rationale is that the special tax rules permitted small mutual property and liability insurers provides a competitive advantage to those companies as compared to stock companies and larger mutuals. It suggests that the application of these rules requires arbitrary distinctions between underwriting and investment income and unnecessarily complicates the tax rules. It, therefore, recommends the repeal of the special tax exemptions, rate reductions and deductions of small mutual companies effective for years beginning on or after January 1, 1986 which would be phased in over a five-year period.

Analysis

The reason cited for the elimination of these provisions is that they "provide a competitive advantage to (small companies) vis-a-vis stock companies and larger mutual companies." This not only ignores but aggravates the inherent competitive disadvantage under which small companies operate which was considered in justifying these provisions initially. More specifically, two surveys of approximately 500 small mutual companies indicated that a tax increase over 1983 and 1984 actual results of about 140 and 125 percent respectively, would result from the repeal of these provisions. For both years surveyed the average increase would amount to about a 7 percent increase in premiums which is more than what the marketplace would bear (see Exhibits A and B attached.) As evidenced by these Exhibits the impact on the affected companies is significant while the overall revenue to be raised is negligible. Thus, a change that creates economic chaos for the sake of change cannot be justified.

Moreover, it is interesting to note that the analysis accompanying the proposal suggests that the proposal would "reduce tax induced distortions that favor the sale of insurance through small firms." It is difficult to comprehend the objective Treasury has in mind. In addition, we fail to see how a distortion arises from the economic delivery of a needed product.

Although laboring under a number of competitive disadvantages the farm mutual or small mutual insurance company serves a valuable and essential role in the insurance marketplace. The authorized writing territory of farm mutuals is one county or contiguous counties within a state. The premium writing is generally less than one million. In fact, of the 800 NAMIC farm mutual members, nearly 500 are developing less than $500,000 of gross income (premium plus investment income). Operating with a concentrated book of business, spending higher dollars for reinsurance, doing business without the availability of economies of scale, not having the law of large numbers available - the farm mutual has provided the major source of insurance protection to the farming communities.

Contrary to the larger insurance company, as illustrated in Exhibit C, the small mutual insurance company must maintain a higher relationship of surplus to premium writings. The reason is basic - the farm mutual insurance company assumes a small number of large farm risks.

The tax statute revision of 1962 permitted a faster generation of surplus capital for the small mutual insurance company with less than $500,000 gross receipts. By 1985, inflation has eroded the tax benefit granted by the 1962 Act. Consequently, the qualifying brackets for small mutual insurance companies should be $352,530 gross receipts to determine exempt status and $1,175,100 for those companies taxed solely on investment income (Predicated on 1984 C.P.I. - 235.02 percent).

Certain mutual property and liability companies have been exempt from tax since 1924. The exemption is not of an incentive nature but rather is in recognition of the need for the availability of true mutual insurance in rural communities.

Commencing in 1924 until the Revenue Act of 1942, all mutual property and liability companies were entirely exempt from tax. In 1942, Congress further clarified the exemption to make certain that only those mutuals that were of a small size and true providers of insurance to farm and rural communities were exempt. The change adopted a numerical benchmark to determine those companies that were exempt. Only mutual property and liability companies with gross income which did not exceed $75,000 were exempt. Attached as Exhibit D are excerpts of the various statutes and committee reports for the 1924, 1938, 1939 and 1942 Acts. Reference should be made to the last sentence in the Senate Finance Committee Report under the 1942 Act, which reads as follows:

> "Accordingly, these provisions will impose no hardship upon farmers' or other small and local mutual insurance companies other than life or marine."

This sentence, as well as the colloquy that follows (on the copied page) indicates the concern of Congress to make certain that the property and liability mutual companies providing coverage in farm and rural areas continue to be able to operate competitively.

Thus, there is a need to recognize that, rather than providing an incentive for an otherwise economically unfeasible company, the benefits extended these companies allow them to continue to maintain their necessary role in their very special economic environment. The $75,000 benchmark was retained in the 1954 Internal Revenue Code, and remained unchanged until the Revenue Act of 1962. In that Act, the exemption benchmark was increased from $75,000 to $150,000.

The financial condition of the farming communities emphasizes the need for maintaining a financially strong farm mutual insurance industry. As farmers face increased operating costs with low commodity prices, the farm mutual can continue to offer insurance protection at a reasonable cost. This factor is especially critical in 1985 since a number of multi-line companies, having previously entered the farm insurance market, withdrew due to an inability to handle this business. Denial of the benefit of these tax provisions will make it difficult for this important segment of our economy to obtain needed insurance coverage. The longstanding public policy of providing special rules for this segment of the insurance industry should not be disturbed especially in view of the small amount of tax revenue that would result.

This impact on the small company is illustrated in Exhibits E and F. Note the decline in premium writings from 1981 through 1983 for 477 small NAMIC members. Since the premium base was declining, the companies were forced to dip into the policyholder surplus to pay losses and expenses. If the companies had not built a solid policyholder surplus in the good years, they would not be able to respond to the market void. Exhibit E also shows the additional drain on policyholder surplus if the exemption and investment income tax provision are eliminated. Exhibit F illustrates the same results for just one NAMIC company.

Conclusions

The significant role served by small mutuals in our economy is the basis for their longstanding tax status rather than their business. Thus, a proposal to revamp the way insurance companies are taxed should not be an occasion to remove a tax exemption which is as worthy as that of any other exempt organization that furthers the common good. The problem is compounded by the fact that for state taxation purposes these companies enjoy a similar exemption based on existing federal tax provisions.

DIVIDENDS TO POLICYHOLDERS

Current Law

Mutual property and liability insurance companies have never been limited as to their deductions for dividends to policyholders. Since the advent of the current tax formula which was provided for in the Revenue Act of 1962 applicable commencing January 1, 1963 an unlimited deduction has been provided for dividends to policyholders. In point of fact, property and liability companies have never been limited as to dividends to policyholders - in contrast to life insurers, both stock and mutuals, which were limited under the 1959 Life Tax Act. Moreover, a review of the Committee Reports, Hearings and other surrounding documents in connection with the Revenue Act of 1962 reveal no discussion whatsoever as to any consideration of limiting dividends to policyholders of mutual property and liability companies as was the case with the 1959 Life Act which was before Congress only three years earlier. It would seem rather apparent that if Congress had intended to apply a similar rationale to mutual property and liability companies that they would have done so having considered the mutual property and liability formula only three years after having considered the life formula.

The 1984 Life Tax Act has introduced a new concept for limiting a mutual life company's deduction for policyholder dividends. The rationale behind the 1984 Act was buttressed by an analysis of policyholders "wearing two hats", one as an owner and one as consumer-purchaser of insurance. It was this analysis that was utilized to arrive at a concept referred to as a "differential earnings rate". In computing the differential earnings rate, the imputed earnings rate for 1984 was established at 16.5%. Together this concept was applied to accomplish segment balance.

> "The Congress anticipated that this 16.5 percent rate will result in the mutual segment of the industry bearing 55 percent of the aggregate industry tax burden for 1984. The Congress believed that this is appropriate in the light of a number of factors including the historic allocation of the industry's tax burden, the relative percentages of assets held by the stock and mutual segments of the industry and the difference in treatment of mutual company policyholders and stock company shareholders." (P. 613 of General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 - December 31, 1984)

Proposal

The Proposal would reduce the policyholder dividend deduction allowed mutual property and liability companies. Such reduction would be effective January 1, 1986, and would be similar to the one provided in the 1984 Life Act for mutual life companies. This limitation, as it applies to life companies is predicated on what stock life companies pay as dividends to stockholders as a percentage of their surplus. A comparison is then made to the surplus of mutuals and this is, in effect, the determination of what should have been paid to policyholders in their capacity as owners. For life companies it is emphasized that this is not merely a limitation on policyholder dividends but rather is the creation of taxable income. Thus, despite the fact that a mutual property and liability company may not pay policyholder dividends it would be burdened with what is tantamount to a "surplus" tax. The Proposal, as contrasted with the Treasury I proposal, suggests that "additional study is needed to determine the size of the competitive advantage that the current treatment of policyholder dividends provide to mutual property and casualty companies and to set the appropriate deduction limitation."

Analysis

Comments in the Proposal contrast mutual and stock property and liability companies. More specifically, the comments note that the full deduction by mutuals results in a competitive disadvantage for stock companies and continue by stating that this competitive disadvantage was recognized in the 1984 Life Tax Act.

The comments to the proposal imply that policyholder dividends paid by mutuals are substantially larger than those paid by stock companies. The attached schedule comparing dividends paid by stock and mutual property and liability companies indicate that stock companies pay greater dividends than mutuals. An analysis of dividends paid by mutual property and liability companies would indicate that a preponderance of those dividends are paid as part of workers' compensation writings. (See Exhibit G.)

Also noteworthy, are Committee Reports to the 1984 Life Tax Act which state that (since) "the average post-dividend, pre-tax return on equity of mutual companies falls below that for a comparable group of stock companies, ...Congress believed that this difference is attributable to distribution by mutual companies of earnings to their owners." The attached schedule, however, indicates that for property and liability companies, net income before dividends and federal taxes as a percentage of average policyholders equity is comparable for mutuals and stocks. There is virtually little distinction between the mutuals and stocks in this regard. This would appear to belie the rationale for a policyholder dividend limitation for property and liability companies. (See Exhibit G.)

Moreover, the second portion of Exhibit G, dealing with net income as a percentage of average policyholders surplus, indicates a comparable percentage for stock versus mutual property and liability companies for the period 1979 through 1982. The 1983 increase in mutual return as compared to stock return has to be viewed as an aberration. Reinsurers suffered during the downward cycle of 1983 and 1984 to a much greater extent than normal. Since reinsurers are predominantly stock companies, the return on surplus, stock versus mutual, is distorted. This in part explains the 1983 six point spread. Moreover, the results of commercial coverage were the most disastrous and the earliest business that deteriorated, as compared to personal lines. A preponderance of commercial business is written by stock companies.

There are other reasons for such a large spread, not the least of which is that certain mutuals adjusted their underwriting standards at a much earlier stage than the large stock companies who were unquestionably looking for volume in an attempt to show return on investment for their stockholders.

There is also a significant conceptual distinction in the dividend distributions made to policyholders by life insurers as compared to property and liability insurers. The property and liability industry pays dividends as a return of premium. In fact, some mutuals as a matter of company policy do not pay dividends to policyholders but reduce the price at the time of entering the contract. This practice is called deviation and is a marketing concept as is the return of premium. Dividends to policyholders or return of premium paid by mutual property and liability companies is not a distribution of profit. In point of fact, it most often is nothing more than a rating mechanism used for competitive purposes. This point may be graphically illustrated by the fact that dividends are not paid to all policyholders as a group, as is the case in life insurance. Dividends to policyholders or return of premium by mutual property and liability companies are usually paid to individual customers by line of business, by state, rating territory, or rating classification and often are indistinguishable from premium adjustments based on loss experience of specific policyholders.

Dividends often are paid in years where a company suffers an underwriting loss. On the other hand, many mutual property and liability companies have not paid a dividend to policyholders during the last 20 years. Thus, the analogy to the life industry and the 1984 Revenue Act changes is not a proper reference to determine the status of policyholders of mutual property and liability companies.

Conclusion

The proposal to limit the deduction for policyholder dividends paid by property and liability companies is based on the mistaken assumption that mutual life and mutual property and liability companies are similarly situated taxpayers. Their business is different and their relationships with policyholders are different. These differences have long been recognized by prior statutory enactments.

QUALIFIED RESERVE ACCOUNT

Current Law

Since the Revenue Act of 1921, property and liability insurers have been permitted a deduction for estimates of unpaid losses on those insured events that have occurred both reported and incurred but not reported (IBNR). The rationale has been that statutory accounting is to be followed for tax purposes. The IRS during the course of its examination of property and liability company tax returns test estimates of unpaid loss reserve to determine whether in fact they were reasonable. These estimates may at times prove to be redundant or deficient. Generally, no discounting element is included.

Proposal

A qualified Reserve Account (QRA) would be established by line of business and year of policy issuance effective for losses incurred in tax years beginning after 1985 that are insured under policies issued after 1985. The initial increase in reserve cannot exceed the total of the statutory unearned premium reserve, IBNR reserve, and reported reserve.

Once established, the QRA would be increased annually by a portion of the after-tax rate of return earned on a company's investments. This involves the proration of taxable and tax-exempt income among reserves and surplus.

The proposals also provide for reserve strengthening and weakening. The determination as to whether a strengthening is appropriate would be governed by objective factors including whether a strengthening has occurred for annual statement purposes. The proposals allow for a voluntary release of excessive reserves that is tantamount to a weakening.

The proposals establish a time frame for which reserves can be maintained and also stipulate that the provisions apply to life insurer's casualty business.

Policyholders would be allowed to disregard the prospect of recovery and elect to deduct a loss in the year it is incurred as if the loss were uninsured. Insurance proceeds would be taxable when received, and a portion could be excluded to the extent the loss did not provide a tax deduction.

The proposals provide that a third-party assignee would include the consideration received from an assignor in its gross income. Moreover, the payment made by the assignee for the purchase of an annuity would either be a deductible expense at the time of purchase or deductible at the time payment is made to the injured party. Also, the assignee would be considered in constructive receipt of the investment income earned under the annuity.

Analysis

The essence of the QRA approach is the requirement that upon payment of a claim (which is deductible) the QRA is reversed and taxable income is recognized in the amount of the QRA. Investment income earned during the period the reserve is outstanding would continue to be subject to current tax and, in effect, a second tax when the reserve is reversed upon payment. This additional taxable income (as well the tax) will be the same regardless of the initial reserve deduction. The following illustrates this concept:

Assume in all instances that the reserve for a paid loss of $100 is outstanding for three years. Further assume that the after-tax rate return is 10% and the applicable tax rate is 33%. The only variable is the amount of the initial loss reserve.

	Company 1	Company 2	Company 3	Company 4	Company 5
Year 1 -					
Initial loss reserve(1)	$ 85.00	$100.00	$115.00	$ 75.13	$ 65.00
Taxable income (loss)	15.00	-	(15.00)	24.87	35.00
Tax @ 33%	4.95		(4.95)	8.20	11.55
Tax compounded @ 10%/Yr. for 3 years (A)	6.59	-	(6.59)	10.92	15.37
Year 3 -					
QRA balance(2)	113.14	133.10	153.07	100.00	86.52
Paid loss	100.00	100.00	100.00	100.00	100.00
Taxable income (loss)	13.14	33.10	53.07	-	(13.48)
Tax @ 33%(B)	4.33	10.92	17.51	-	(4.45)
Total Economic Cost (A) plus (B)	$ 10.92	$ 10.92	$ 10.92	$ 10.92	$ 10.92

It would appear that the additional taxable income under QRA will be equal to the annual after-tax rate of return times the actual loss paid for each year the loss remains unpaid.

(1) Cannot exceed the sum of the Annual Statement unearned premium reserve, IBNR and reported claim reserve.

(2) Represents the year 1 initial loss reserve compounded @ 10%/year for 3 years.

While this point will be fully briefed by others, we take this opportunity to point out the fallacy of its rationale and danger of its application. The following is a summary of observations pointing out some of the reasons why QRA does not reflect economic income.

- This highly controversial proposal would have the effect of taxing tax exempt income and other net after tax investment income as well as requiring companies to adopt a cash basis method of accounting. This is inconsistent with other proposals narrowly restricting the cash basis method of accounting to certain limited situations.

- QRA would severely erode the profitability of long tail commercial lines. Rather than pass on the effects of QRA to commercial line policyholders, competitive factors instead may dictate having personal line policyholders assume part of this burden. This upward pressure on premiums could result in policyholders that presently insure personal liability, deciding to self insure to the detriment of long standing public policy considerations.

- The policyholder election to deduct losses without regard to the prospect of a future insurance recovery is inconsistent with newly enacted Section 461(h) governing economic performance. This proposal coupled with the proposal to repeal the small mutual company credits, deductions, and rate reductions and the repeal of the PAL account will jeopardize the very existence of small and medium-sized mutual companies.

Other observations include:

- The Treasury in its analysis states "the QRA would be only a bookkeeping entry." However, calculation of the QRA would in fact impose an extremely heavy administrative burden.

- There is presently in effect a mining reserve system that is similar to the proposed QRA, but the proposal would repeal the mining reserve system on the ground that it produces overstated deductions and is extremely complicated. This raises a question as to the appropriateness of applying to the insurance industry an approach which is considered undesirable for the mining industry.

Open questions includes:

- The proposal does not make clear what effect QRA would have on loss adjustment expenses (LAE). While not covered, a change in QRA would influence paid-to-paid LAE calculations.
- The impact of including the unearned premium reserve in the overall limitation for the QRA is unclear, as well as the significance of reporting on the basis of the year a policy is issued.
- There are many questions concerning the calculation of the after-tax rate of return.

Conclusion

The QRA does not properly reflect economic income, is a burden, unworkable, and should not be imposed on the property and liability industry.

Exhibit
Page 1 of 2

namic

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HAROLD W. WALTERS CAE
President

January 30, 1985

TREASURY PROPOSALS FOR PROPERTY & CASUALTY INS. CO. TAXATION

The U.S. Treasury Department has proposed major changes in property and casualty insurance company taxation, including the repeal of special tax exemptions, rate reductions and deductions of small mutual property and casualty insurance companies.

NAMIC did a survey of 477 member companies to assess the impact of this proposal on small companies. The survey covered 117 NAMIC members with Gross Income (GI) of $0 - $150,000, and 360 companies in the $150,000 - $500,000 Gross Income category. The following data compares 1983 actual results with the effects of the Treasury proposal, which would increase taxes by 140 percent:

COMPANIES WRITING $0 - $150,000 GI

NO. COS. SURVEYED: 117

ACTUAL RESULTS - 1983

TOTAL FEDERAL TAXES PAID IN 1983: $0

AVERAGE FEDERAL TAXES PER CO. IN 1983: $0

COMPARISON UNDER TREASURY PROPOSAL

TOTAL RESULTING FEDERAL TAX FOR COS. SURVEYED: $476,440

AVERAGE RESULTING FEDERAL TAX PER COMPANY: $4,072

TOTAL RESULTING INCREASE: $476,440

AVERAGE RESULTING INCREASE PER CO.: $4,072

RESULTING % OF NET WRITTEN PREMIUM: 8.54%

Exhibit
Page 2 of

COMPANIES WRITING $150,000 - $500,000 GI

NO. COS. SURVEYED:	360

ACTUAL RESULTS - 1983

TOTAL FEDERAL TAXES PAID IN 1983:	$2,729,000
AVERAGE FEDERAL TAXES PER CO. IN 1983:	$10,577

COMPARISON UNDER TREASURY PROPOSAL

TOTAL RESULTING FEDERAL TAX FOR COS. SURVEYED:	$5,948,980
AVERAGE RESULTING FEDERAL TAX PER COMPANY:	$16,525
TOTAL RESULTING INCREASE:	$3,219,980
AVERAGE RESULTING INCREASE PER COMPANY:	$5,948
RESULTING % OF NET WRITTEN PREMIUM:	9.67%

TOTAL FEDERAL TAX FOR BOTH PREMIUM GROUPS UNDER TREASURY PROPOSAL:	$6,425,440
TOTAL INCREASE FOR BOTH PREMIUM GROUPS UNDER TREASURY PROPOSAL:	$3,696,420 (140% increase)

Exhibit B
Page 1 of 9

JULY 11, 1985

TREASURY II PROPOSALS FOR PROPERTY & CASUALTY INS. CO. TAXATION

A survey of 466 NAMIC member companies was conducted to assess the impact of Treasury II on small mutual insurance companies. The following data compares 1984 actual results with the potential effects of the proposal:

GWP Category	NWP	1984 Actual	Proposed * Fed. Tax	% of NWP 1984	% of NWP Proposed
0-$150,000	5,424,000	- 0 - (tax exempt)	740,520		13.7
$150,000-500,000	58,600,000	2,389,217	4,649,040	4.1	7.9
	64,024,000	2,389,217	5,389,560	3.7	8.4

% Increase of Proposed Tax over 1984 Actual Tax: 125.6%

*** Federal corporate tax rate of 33% as proposed in Treasury II.**

State	0-$150,000 Gross Written Premium			$150,000-500,000 Gross Written Premium			
	NWP	Proposed Fed. Tax	Proposed % of NWP	NWP	Actual	Proposed Fed. Tax	Proposed % of NWP
Illinois	1,052,000	93,390	8.9	7,926,000	278,664	482,790	6.1
Indiana	159,000	49,170	30.9	3,284,000	206,388	289,740	8.8
Iowa	170,000	36,630	21.5	6,230,000	246,518	424,710	6.8
Minnesota	620,000	98,670	15.9	14,109,000	500,042	853,050	6.0
Missouri	699,000	68,970	9.9	6,057,000	170,197	549,120	9.1
Nebraska	147,000			635,000	35,845	87,450	13.8
New York	30,000	5,610	18.7	1,806,000	98,496	221,430	12.3
N. Carolina				1,251,000	85,157	66,330	5.3
N. Dakota	223,000	22,110	9.9	1,177,000	36,754	104,280	8.9
Ohio	352,000	14,520	4.1	3,443,000	125,795	145,200	4.2
Pennsylvania	205,000	76,890	37.5	1,407,000	89,777	156,750	11.1
S. Dakota	374,000	40,260	10.8	1,147,000	36,695	168,960	14.7
Wisconsin	566,000	47,190	8.3	6,733,000	319,680	609,180	9.0
All Others	827,000	187,110	22.6	3,395,000	159,209	490,050	14.4
TOTAL	5,424,000	740,520	13.7	58,600,000	2,389,217	4,649,040	7.9

* Gross written premium and other income is used to determine tax structure.

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HISTORY BY STATE

GWP Category	# of Cos.	NWP	1984 Actual	Proposed Fed. Tax	% of NWP 1984	% of NWP Prop.
ILLINOIS						
(gross income) 0-$150,000	24	$1,052,000		$93,390	-	8.9
(gross income) $150,000-500,000	52	7,926,000	278,664	482,790	3.5	6.1
		8,978,000	278,664	576,180	3.1	6.4
	% Increase of Proposed Tax over 1984 Actual Tax:					107%
	Individual company examples					
	#212	$80,000	$ 358	$13,530	.4	17.0
	#224	85,000	1,126	16,500	1.3	19.4
	#112	328,000	9,508	25,740	2.9	7.8
	#128	228,000	4,162	26,400	1.8	11.6
INDIANA						
(gross income) 0-$150,000	5	$159,000		$49,170		30.9
$150,000-500,000	18	3,284,000	206,388	289,740	6.3	8.8
		3,443,000	206,388	338,910	6.0	9.8
	% Increase of Proposed Tax over 1984 Actual Tax					64.0
	Individual company examples					
	#134	$173,000	$6,942	$23,100	4.0	13.4
	#795	144,000	5,771	35,640	4.0	24.8
	#969	309,000	22,504	62,040	7.3	20.1

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GWP Category	# of Cos.	NWP	1984 Actual	Proposed Fed. Tax	$ of NWP 1984	$ of NWP Prop.
IOWA						
(gross income) 0-$150,000	4	$170,000		$ 36,630		21.5
(gross income) $150,000-500,000	36	6,230,000	246,518	424,710	4.0	6.8
		6,400,000	246,518	461,340	3.9	7.2

% Increase of Proposed Tax over 1984 Actual Tax: 87%

Individual company examples

#325	$204,000	$ 4,800	$ 19,140	2.4	9.4
#458	216,000	13,067	44,220	6.0	20.5
#811	169,000	6,489	34,650	3.8	20.5

GWP Category	# of Cos.	NWP	1984 Actual	Proposed Fed. Tax	$ of NWP 1984	$ of NWP Prop.
MINNESOTA						
(gross income) 0-$150,000	14	$620,000		$ 98,670		15.9
(gross income) $150,000-500,000	77	14,109,000	500,042	853,050	3.5	6.1
		14,729,000	500,042	951,720	3.4	6.5

% Increase of Proposed Tax over 1984 Actual Tax: 90%

Individual company examples

#411	$100,000	$3,145	$20,790	3.1	20.8
#1205	106,000	354	22,110	.3	20.9
#1101	238,000	2,781	42,570	1.2	17.9

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GWP Category	# of Cos.	NWP	1984 Actual	Proposed Fed. Tax	% of NWP 1984	Prop.
MISSOURI						
(gross income) 0-$150,000	12	$699,000		$68,970		9.9
(gross income) $150,000-500,000	36	6,057,000	170,197	549,120	2.8	9.1
		6,756,000	171,866	618,090	2.5	9.1
	% Increase of Proposed Tax over 1984 Actual Tax:					260%
	Individual company examples					
	#724	$252,000	$3,400	$27,390	1.3	10.9
	#60	213,000	6,632	13,860	3.1	6.5
	#61	114,000	1,194	26,730	1.0	23.4
NEBRASKA						
(gross income) 0-$150,000	3	$147,000				
(gross income) $150,000-500,000	4	635,000	35,845	87,450	5.6	13.8
		782,000	35,845	87,450	4.6	11.2
	% Increase of Proposed Tax over 1984 Actual Tax:					144%
	Individual company examples					
	#1160	$193,000	$3,392	$15,180	1.8	7.9
	#1351	172,000	21,266	40,260	12.4	23.4
	#1462	108,000	6,310	25,080	5.8	23.2

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GWP Category	# of Cos.	NWP	1984 Actual	Proposed Fed. Tax	% of NWP 1984	% of NWP Prop.
NEW YORK						
(gross income) 0-$150,000	2	$30,000		$ 5,610		18.7
(gross income) $150,000-500,000	10	1,806,000	98,496	221,430	5.5	12.3
		1,836,000	98,496	227,040	5.4	12.4
	% Increase of Proposed Tax over 1984 Actual Taxes: 131%					
	Individual company examples					
	#735	$145,000	$ 9,885	$12,870	6.8	8.9
	#742	218,000	8,254	44,880	3.8	20.6
	#849	134,000	1,500	4,290	1.1	3.2
NORTH CAROLINA						
(gross income) 0-$150,000	0					
(gross income) $150,000-500,000	8	1,251,000	85,157	66,330	6.8	5.3
	% Decrease of Proposed Tax over 1984 Actual Taxes: 22%(decrease					
	Individual company examples					
	#559	$151,000	$18,953	$ 2,640	12.6	1.7
	#1213	245,000		16,170		6.6
	#1336	161,000	64,805	34,320	40.3	21.3

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GWP Category	# of Cos.	NWP	1984 Actual	Proposed Fed. Tax	$ of NWP 1984	$ of NWP Prop.
NORTH DAKOTA						
(gross income) 0-$150,000	8	$223,000		$ 22,110		9.9
(gross income) $150,000-500,000	7	1,177,000	36,754	104,280	3.1	8.9
		1,400,000	36,754	126,390	2.6	9.0
% Increase of Proposed Tax over 1984 Actual Tax:						244%
Individual company examples						
	#645	$137,000	$ 6,500	$30,030	4.7	21.9
	#944	254,000	6,153	16,170	2.4	6.4
	#1437	260,000	1,173	30,030	.5	11.6
OHIO						
(gross income) 0-$150,000	6	$352,000		$14,520		4.1
(gross income) $150,000-500,000	20	3,443,000	125,795	145,200	3.7	4.2
		3,795,000	125,795	159,720	3.3	4.2
% Increase of Proposed Tax over 1984 Actual Tax:						27%
Individual company examples						
	#745	$131,000	$ 1,364	$13,530	1.0	10.3
	#747	179,000	8,029	38,280	4.5	21.4
	#1067	161,000	2,666	7,260	1.7	4.5

GWP Category	# of Cos.	NWP	1984 Actual	Proposed Fed. Tax	$ of NWP	
					1984	Prop.
PENNSYLVANIA						
(gross income) 0-$150,000	6	$205,000		$76,890		37.5
(gross income) $150,000-500,000	9	1,407,000	89,777	156,750	6.4	11.1
		1,612,000	89,777	233,640	5.6	14.5
	% Increase of Proposed Tax over 1984 Actual Tax:					160%
	Individual company examples					
	#1490	$57,000	$ 3,130	$22,770	5.5	39.9
	#1130	313,000	27,965	40,920	8.9	13.1
	#1526	169,000	24,911	33,990	14.7	20.1
SOUTH DAKOTA						
(gross income) 0-$150,000	11	$374,000		$40,260		10.8
(gross income) $150,000-500,000	8	1,147,000	36.695	168,960	3.2	14.7
		1,521,000	36,695	209,220	2.4	13.8
	% Increase of Proposed Tax over 1984 Actual Tax:					470%
	Individual company examples					
	#1461	$81,000	$ 1,459	$11,220	1.8	13.9
	#1220	339,000	4,198	32,010	1.2	9.4
	#1235	228,000	4,750	46,530	2.5	20.4

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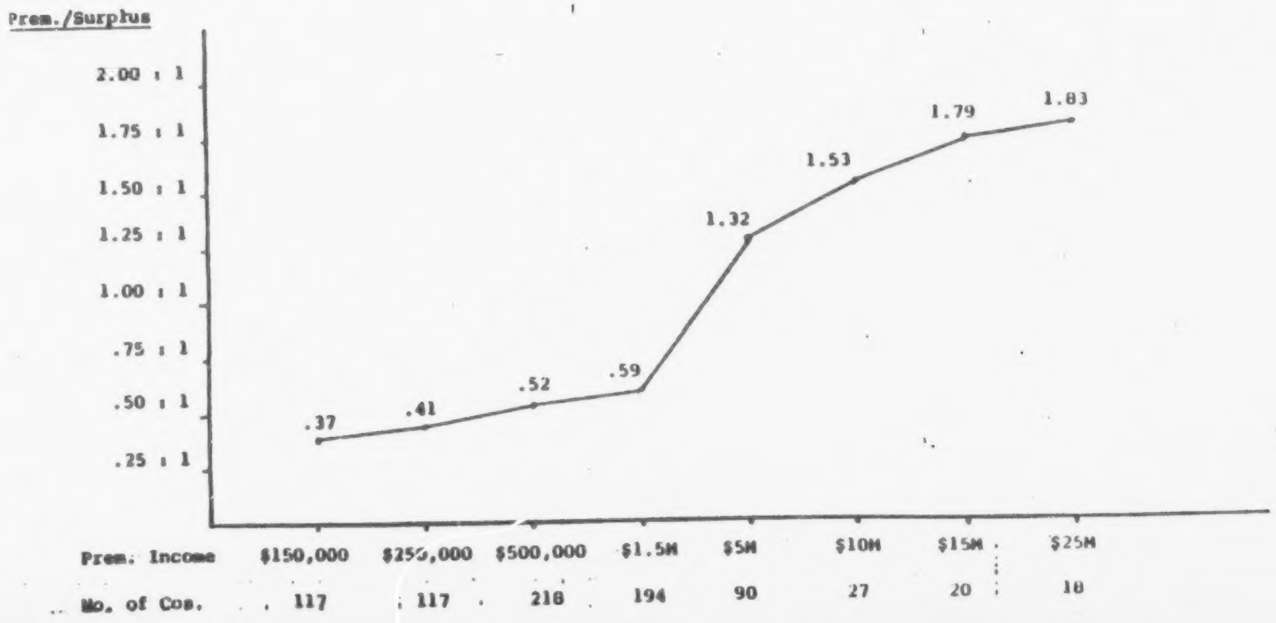
GWP Category	# of Cos.	NWP	1984 Actual	Proposed Fed. Tax	% of NWP 1984	% of NWP Prop.
WISCONSIN						
(gross income) 0-$150,000	10	$566,000		$47,190		8.3
(gross income) $150,000-500,000	37	6,733,000	319,680	609,180	4.7	9.0
		7,299,000	319,680	656,370	4.4	9.0
	% Increase of Proposed Tax over 1984 Actual Tax:					105%
	Individual company examples					
	#1131	$67,000	$ 2,912	$ 4,950	4.3	7.4
	#1044	212,000	8,719	48,510	4.1	22.9
	#1272	210,000	5,802	10,890	2.8	5.2
ALL OTHER STATES						
(gross income) 0-$150,000	15	$827,000		$187,110		22.6
(gross income) $150,000-500,000	24	3,395,000	159,209	490,050	4.7	14.4
		4,222,000	159,209	677,160	3.8	16.0
	% Increase of Proposed Tax over 1984 Actual Tax:					325%
	Individual company examples					
	#1132	116,000	$ 836	$ 5,280	.7	4.6
	#759	126,000	10,550	35,640	8.4	28.3
	#1385	102,000	7,397	50,490	7.3	49.5

1983 PREMIUM TO SURPLUS RATIOS
of
MUTUAL INSURANCE COMPANIES

Based upon examination
of 801 1983 Annual
Statements.



1924 Act'

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[*(3) The term "cash dividends" includes dividends paid in interest-bearing scrip, if subject to tax in the hands of the distributees to the same extent as a dividend paid in cash.*]

CONDITIONAL AND OTHER EXEMPTIONS OF CORPORATIONS.

SEC. 231. The following organizations shall be exempt from taxation under this title—

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily inci-

(10) [Farmers'] BENEVOLENT LIFE INSURANCE ASSOCIATIONS OF A PURELY LOCAL CHARACTER, FARMERS' or other mutual hail, cyclone, casualty, (76)[*life,*] or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, (77)[*or casualty or fire reciprocal or interinsurance exchanges,*] or like organizations; but only if (78)~~substantially all~~ *85 per centum or more of* the income consists of amounts collected from members for the sole purpose of meeting losses and expenses; (79)~~also benevolent mutual life insurance associations not operated for profit, whose business is purely local and wholly for benefit of its members;~~

(11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses;

(12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and

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[Public—No. 554—75th Congress]
[Chapter 289—3d Session]
[H. R. 9682]

AN ACT

To provide revenue, equalize taxation, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act, divided into titles and sections according to the following Table of Contents, may be cited as the "Revenue Act of 1938".

TABLE OF CONTENTS

Title I—Income Tax

SUBTITLE A—INTRODUCTORY PROVISIONS

Sec. 1. Application of title.
Sec. 2. Cross references.
Sec. 3. Classification of provisions.
Sec. 4. Special classes of taxpayers.

SUBTITLE B—GENERAL PROVISIONS

Part I—Rates of Tax

Sec. 11. Normal tax on individuals.
Sec. 12. Surtax on individuals.
Sec. 13. Tax on corporations in general.
Sec. 14. Tax on special classes of corporations.
Sec. 15. Corporate taxes effective for two taxable years.

Part II—Computation of Net Income

Sec. 21. Net income.
Sec. 22. Gross income.
Sec. 23. Deductions from gross income.
Sec. 24. Items not deductible.
Sec. 25. Credits of individual against net income.
Sec. 26. Credits of corporations.
Sec. 27. Corporation dividends paid credit.
Sec. 28. Consent dividends credit.

Part III—Credits Against Tax

Sec. 31. Taxes of foreign countries and possessions of United States.
Sec. 32. Taxes withheld at source.
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Part IV—Accounting Periods and Methods of Accounting

Sec. 41. General rule.
Sec. 42. Period in which items of gross income included.
Sec. 43. Period for which deductions and credits taken.
Sec. 44. Installment basis.
Sec. 45. Allocation of income and deductions.
Sec. 46. Change of accounting period.
Sec. 47. Returns for a period of less than twelve months.
Sec. 48. Definitions.

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hand at the end of the year is retained to meet losses and expenses or is returned to members.

The phrase "of a purely local character" applies to benevolent life insurance associations, and not to the other organizations specified in section 101(10). It applies, however, to any organization seeking exemption on the ground that it is an organization similar to a benevolent life insurance association. An organization of a purely local character is one whose business activities are confined to a particular community, place, or district, irrespective, however, of political subdivisions. If the activities of an organization are limited only by the borders of a State it cannot be considered to be purely local in character.

Here

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.]

[The following organizations shall be exempt from taxation under this title—]

(11) Farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses.

Regs

ART. 101(11)-1. Farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations.—To be exempt under section 101(11) the business of the organization must be purely mutual and its income must be used or held solely for the purpose of paying losses or expenses. Neither the extent of the territory in which the company may properly operate nor the fact that it accepts premium deposits instead of assessments is decisive as to its exemption. The writing of nonmutual insurance regardless of amount will deprive a company of the exemption.

The term "casualty" as used in section 101(11) is limited to those forms of indemnity insurance providing for payment of loss or damage to property or personal injury to third persons resulting from accident or some such unanticipated contingency other than fire or the elements, and does not include indemnity from loss through accident resulting in bodily injury to, or death of, the insured.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.]

[The following organizations shall be exempt from taxation under this title—]

(12) Farmers', fruit growers', or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turn-

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Internal Revenue Code
1939

Printed as Vol. 53, Part 1, U. S. Statutes at Large,

76th Congress, First Session

United States Government Printing Office, Washington, 1939

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SUBCHAPTER C—SUPPLEMENTAL PROVISIONS

Supplement A—Rates of Tax

[Supplementary to Subchapter B, Part I]

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this chapter—

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) *Fraternal* beneficiary societies, orders, or associations, (A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual;

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

(7) Business leagues, chambers of commerce, real-estate boards, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual;

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes;

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder;

(10) Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 per centum or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses;

(11) Farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses;

(12) Farmers', fruit growers', or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses,

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1939 Code

in this paragraph all expenses incurred which are not allowed as deductions by subsection (c) of this section.

(c) DEDUCTIONS ALLOWED.—In computing the net income of an insurance company subject to the tax imposed by this section there shall be allowed as deductions:

(1) All ordinary and necessary expenses incurred, as provided in section 23 (a);

(2) All interest as provided in section 23 (b);

(3) Taxes as provided in section 23 (c);

(4) Losses incurred as defined in subsection (b) (6) of this section;

(5) Subject to the limitation contained in section 117 (d), losses sustained during the taxable year from the sale or other disposition of property;

(6) Bad debts in the nature of agency balances and bills receivable ascertained to be worthless and charged off within the taxable year;

(7) The amount of interest earned during the taxable year which under section 22 (b) (4) is excluded from gross income;

(8) A reasonable allowance for the exhaustion, wear and tear of property, as provided in section 23 (l);

(9) Charitable, and so forth, contributions, as provided in section 23 (q);

(10) Deductions (other than those specified in this subsection) as provided in section 23, but not in excess of the amount of the gross income included under subsection (b) (1) (C) of this section.

(d) DEDUCTIONS OF FOREIGN CORPORATIONS.—In the case of a foreign corporation the deductions allowed in this section shall be allowed to the extent provided in Supplement I in the case of a foreign corporation engaged in trade or business within the United States or having an office or place of business therein.

(e) DOUBLE DEDUCTIONS.—Nothing in this section shall be construed to permit the same item to be twice deducted.

SEC. 205. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section 201, 204, or 207, to the extent provided in the case of a domestic corporation in section 131, and in the case of the tax imposed by section 201 or 204 "net income" as used in section 131 means the net income as defined in this Supplement.

SEC. 206. COMPUTATION OF GROSS INCOME.

The gross income of insurance companies subject to the tax imposed by section 201 or 204 shall not be determined in the manner provided in section 119.

SEC. 207. MUTUAL INSURANCE COMPANIES OTHER THAN LIFE.

Mutuals other than casualty companies

(a) IMPOSITION OF TAX.—

(1) IN GENERAL.—There shall be levied, collected, and paid for each taxable year upon the special class net income of every mutual insurance company (other than a life insurance company) a tax equal to 16½ per centum thereof.

(2) FOREIGN CORPORATIONS.—The tax imposed by paragraph (1) shall apply to foreign corporations as well as domestic corporations; but foreign insurance companies not carrying on an insurance business within the United States shall be taxable as other foreign corporations.

(b) GROSS INCOME.—Mutual marine-insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.

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(c) Deductions.—In addition to the deductions allowed to corporations by section 23 the following deductions to insurance companies shall also be allowed, unless otherwise allowed—

(1) Mutual insurance companies other than life insurance.—In the case of mutual insurance companies other than life insurance companies—

(A) the net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and

(B) the sums other than dividends paid within the taxable year on policy and annuity contracts.

(2) Mutual marine insurance companies.—In the case of mutual marine insurance companies, in addition to the deductions allowed in paragraph (1) of this subsection, unless otherwise allowed, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof;

(3) Mutual insurance companies other than life and marine.—In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves.

Supplement H—Nonresident Alien Individuals

~~SEC. 211. TAX ON NONRESIDENT ALIEN INDIVIDUALS.~~

~~(a) No United States Business or Office.—~~

~~(1) General rule.—~~

~~(A) Imposition of tax.—There shall be levied, collected, and paid for each taxable year, in lieu of the tax imposed by sections 11 and 12, upon the amount received, by every nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein, from sources within the United States as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, a tax of 10 per centum of such amount, except that such rate shall be reduced, in the case of a resident of a contiguous country, to such rate (not less than 5 per centum) as may be provided by treaty with such country.~~

~~(B) Cross reference.—~~

~~For inclusion in computation of tax of amount specified in shareholder's consent, see section 28.~~

~~(2) Aggregate more than $21,600.—The tax imposed by paragraph (1) shall not apply to any individual if the aggregate amount received during the taxable year from the sources therein specified is more than $21,600.~~

~~(3) Residents of contiguous countries.—Despite the provisions of paragraph (2), the provisions of paragraph (1) shall apply to a resident of a contiguous country so long as there is in effect a treaty with such country (ratified prior to August 26, 1937) under which the rate of tax under section 211 (a) of the Revenue Act of 1936, 49 Stat. 1714, prior to its amendment by section 501 (a) of the Revenue Act of 1937, 50 Stat. 830, was reduced.~~

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SEIDMAN'S
LEGISLATIVE HISTORY
of
FEDERAL INCOME AND EXCESS PROFITS TAX LAWS

1953-1939

1942 ACT
EXTRACTS

by

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Member, the New York Bar

Author of
Seidman's Legislative History
of Federal Income Tax Laws
(1938-1861)
Seidman's Legislative History
of Excess Profits Tax Laws
(1946-1917)

IN TWO VOLUMES

Vol. I
Through Code Sec. 166

NEW YORK
PRENTICE-HALL, INC.
1954

Exhibit D

Sec. 101(10)

LEGISLATIVE HISTORY 1938-1861

Set forth in *Seidman's Legislative History of Federal Income Tax Laws (1938-1861)* as follows:

ACT	SECTION	PAGE
1926	231(10)	807
1924	231(10)	751
1918	11(a)(10th)	976

Sec. 101(11)

EXTRACT FROM
COMM. HEE REPORTS
1942 ACT

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.]

1942
166 a

(11) ~~Mutual hail, cyclone, casualty, liability, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) writing insurance contracts solely on a mutual basis, if the mean of the ledger assets held at the beginning and end of the taxable year does not exceed $100,000;~~ *Mutual insurance companies or associations other than life or marine (including interinsurers and reciprocal underwriters) <writing no insurance contracts other than mutual insurance contracts> if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75.000;*

Committee Reports

Report—Ways and Means Committee (77th Cong., 2d Sess., H. Rept. 2333).—The revenue derived from mutual insurance companies is negligible. The reason lies in the broad language of the exemption provision and in the ineffective language of the taxing provisions. Section 144 of the bill makes the exemption provision explicit, limiting it to companies of designated size. (p. 27-28)

Most mutual insurance companies other than life, large as well as small, are given an outright exemption from taxation under section 101 (11), although that section was originally designed to exempt only small and local mutual companies. The remaining mutual companies, with a few exceptions, ordinarily pay no tax under the present method of computing their income even though not specifically exempted from the tax.

The exemption provided in section 101 (11) has been revised so that it will be limited to mutual companies or associations (including interinsurers and reciprocal underwriters) writing insurance contracts solely on a mutual basis if the mean of the ledger assets held at the beginning and end of the taxable year does not exceed $100,000. Practically all of the farmers' and other small and local mutual companies have ledger assets of less than $100,000 and accordingly will not be required to file income tax returns or pay any income taxes. It is estimated that over 90 percent of all companies will be exempt from filing returns under this provision. In addition, even where ledger assets exceed $100,000, and an income tax return must be filed, it is provided under section 207 (a) that no income tax is payable unless the corporation surtax net income

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(which may be greater than, but can never be less than, the normal tax net income) is over $50,000. Only the larger companies will pay a tax under these provisions. Accordingly, these provisions will impose no hardship upon farmers' or other small and local mutual insurance companies other than life. (p. 113)

New small company exemption

Report—Senate Finance Committee (77th Cong., 2d Sess., S. Rept. 1631).—This section corresponds to section 147 of the House bill which revised the exemption in section 101 (11) of the Code so that it would be limited to "mutual hail, cyclone, casualty, liability, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) writing insurance contracts solely on a mutual basis, if the mean of the ledger assets held at the beginning and end of the taxable year does not exceed $100,000" and subjected such companies to income tax on the sum of their investment and underwriting income in a manner somewhat similar to that used under section 204 (relating to insurance companies other than life or mutual). Your committee has changed the exemption and completely revised the method of taxing such companies.

Reference to fact that many other mutual insurers are taxed

Most mutual insurance companies other than life, large as well as small, are given an outright exemption from taxation under the existing section 101 (11), although that section was originally designed to exempt only small and local mutual companies. The remaining mutual companies, with a few exceptions, ordinarily pay no tax under the present method of computing their income even though not specifically exempted from the tax.

The exemption provided in section 101 (11) of the Code, as revised by the House bill, is further revised so that it will be limited to "mutual insurance companies or associations, other than life or marine (including interinsurers and reciprocal underwriters) writing no insurance contracts other than mutual insurance contracts, if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000." The gross amount received from interest, dividends, rents, and premiums of practically all of the farmers' and other small and local mutual companies is less than $75,000 and accordingly they will not be required to file income-tax returns or pay any income taxes. It is estimated that over 80 percent of all companies will be exempt from filing returns under this provision. In addition, even where such gross amount received exceeds $75,000, and an income tax return must be filed, it is provided under section 207 (a) that no income tax is payable if the corporation surtax net income (which may be greater than, but can never be less than, the normal-tax net income) is $3,000, or less, and the gross amount received from interest, dividends, rents, and net premiums, minus the dividends to policyholders, minus the interest which under section 22 (b) (4) is excluded from gross income is $75,000 or less. Accordingly, these provisions will impose no hardship upon farmers' or other small and local mutual insurance companies other than life or marine. (p. 150-151)

Congressional Discussion

Discussion—Senate (Cong. Rec. Vol. 88).—Mr. LANGER. That will cover an ordinary farm insurance company?

Mr. GEORGE. Oh, yes.

Mr. LANGER. The tax is 1 percent now?

Mr. GEORGE. Approximately 80 percent of the small farm mutuals are exempt under the provision, which does not impose a tax at all if the income from premiums, rents, interest, dividends, and so forth, does not exceed $75,000 in the taxable year. (p. 7801)

Mr. LA FOLLETTE. Mr. President, I invite the attention of the Senator from Georgia to the amendment beginning on page 248, line 9, under the heading "Exempt Com-

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panies." Beginning with line 13 the language is:

> (11) Mutual insurance companies or associations other than life or marine (including interinsurers and reciprocal underwriters) writing no insurance contracts other than mutual insurance contracts—

And so forth. I should like to suggest to the Senator from Georgia the wisdom of striking out the words "writing no insurance contracts other than mutual insurance contracts." It was called to our attention during the discussion in the subcommittee that this language is subject to confused interpretation. It has been brought to my attention and I have conferred with Mr. Stam, of the joint committee staff, about it, and he sees no objection to these words being stricken. I therefore move to strike out in line 15, the words "writing no insurance contracts other than mutual insurance contracts."

Mr. GEORGE. Mr. President, I have no objection to striking those words. There is some doubt about the language there used expressing precisely what is intended. That would put that feature of it in conference. The whole section might be in conference anyway. I have no objection to striking out those words. (p. 7823)

Discussion—House; on Report of Conference Committee (Cong. Rec. Vol. 88).—Mr. TREADWAY. * * * There has been considerable interest in the provisions of the bill relating to mutual fire and casualty insurance companies. Under existing law, these mutual companies are completely exempt from income tax. Under the House bill, those having net income in excess of $50,000 and assets in excess of $100,000 were made subject to tax. The Senate has changed the exemption to $75,000, and substantially changed the basis of taxation of companies made subject to tax. The conference agreement adopts the Senate amendments, which are desired by the mutual companies. Stock insurance companies, which compete with the mutual companies for business, favored the House provisions. (p. 8470)

Committee Hearings

Hearings—Ways and Means Committee.—Limiting exemption. (R. Paul—Treas. Dept.—p. 87)

Objections to limitations. (A. V. Gruhn, p. 2314-16; H. L. Ekern, p. 2317-27; H. T. Freeman, p. 2328-30; C. M. Howell, p. 2344-45)

Exempting only small mutual insurance companies. (C. C. Chapelle, p. 2349-50)

Hearings—Senate Finance Committee.—Explanation of provision. (J. O'Brien—Treas. Dept.—p. 98-100)

Objections to limitations. (H. P. Cooper, p. 1975-76; A. V. Gruhn p. 2001-16; H. L. Ekern, p. 2032-34)

1941 Act

Hearings—Ways and Means Committee.—Clarifying definition of mutual insurance companies. (C. C. Chapelle, p. 320-321; E. A. O'Neal, p. 1686-90)

UNENACTED RELATED PROVISIONS

[Sec. 107 (d) of Senate bill]

This provision, stricken by the Conference Committee, had to do with stock accident and health insurance companies. It provided, through proposed sec. 101(21) of the Code, for an exemption from tax of such companies with gross receipts of less than $200,000. Applicable legislative history references are:

Report—Conference Committee (77th Cong., 2d Sess., H. Rept. 2586).
Discussion—Senate (Cong. Rec. Vol. 88, p. 8041-42).
Discussion—Senate; on Report of Conference Committee (Cong. Rec. Vol. 88, p. 8410).

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Senate Finance Rept

not qualifying as a life insurance company. This change is to permit a deduction under this section for life insurance reserves for which the company would receive a policy and other liability credit under sections 202 and 203 if it could qualify under section 201 as a life insurance company. Subsection (c) corresponds to subsection (b) of the House bill but contains a new provision amending subsection 204 (c) (relating to deductions) by revising paragraph (5) so that companies subject to the tax imposed by this section will be allowed the same deduction for capital losses provided in section 117 and the same provisions with respect to losses from capital assets sold or exchanged in order to provide funds to meet abnormal insurance losses as are allowed under section 207 to mutual insurance companies other than life or marine. The application of the capital loss carry-over provided in section 117 (*e*) for the purposes of this section will be subject to the same limitations as in section 207 relating to mutual insurance companies other than life or marine. Subsection (c) eliminates paragraphs (11), (12), and (13) of the proposed amendment to section 204 (c) in the House bill and inserts a new paragraph to provide a deduction for the few participating stock companies which pay dividends and similar distributions to policyholders analogous to the dividends paid by mutual companies. This would also allow a deduction for such distributions made by mutual marine insurance companies.

SECTION 167. MUTUAL INSURANCE COMPANIES OTHER THAN LIFE OR MARINE

This section corresponds to section 147 of the House bill which revised the exemption in section 101 (11) of the Code so that it would be limited to "mutual hail, cyclone, casualty, liability, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) writing insurance contracts solely on a mutual basis, if the mean of the ledger assets held at the beginning and end of the taxable year does not exceed $100,000" and subjected such companies to income tax on the sum of their investment and underwriting income in a manner somewhat similar to that used under section 204 (relating to insurance companies other than life or mutual). Your committee has changed the exemption and completely revised the method of taxing such companies.

Most mutual insurance companies other than life, large as well as small, are given an outright exemption from taxation under the existing section 101 (11), although that section was originally designed to exempt only small and local mutual companies. The remaining mutual companies, with a few exceptions, ordinarily pay no tax under the present method of computing their income even though not specifically exempted from the tax.

The exemption provided in section 101 (11) of the Code, as revised by the House bill, is further revised so that it will be limited to "mutual insurance companies or associations, other than life or marine (including interinsurers and reciprocal underwriters) writing no insurance contracts other than mutual insurance contracts, if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000." The gross amount received from interest, dividends, rents,

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and premiums of practically all of the farmers' and other small and local mutual companies is less than $75,000 and accordingly they will not be required to file income-tax returns or pay any income taxes. It is estimated that over 90 percent of all companies will be exempt from filing returns under this provision. In addition, even where such gross amount received exceeds $75,000, and an income tax return must be filed, it is provided under section 207 (a) that no income tax is payable if the corporation surtax net income (which may be greater than, but can never be less than, the normal-tax net income) is $3,000, or less, and the gross amount received from interest, dividends, rents, and net premiums, minus the dividends to policyholders, minus the interest which under section 22 (b) (4) is excluded from gross income is $75,000 or less. Accordingly, these provisions will impose no hardship upon farmers' or other small and local mutual insurance companies other than life or marine.

In the case of mutual insurance companies other than life or marine which are not granted exemption under section 101 (11), it is proposed to subject such companies to income tax at the regular corporate rates on their net investment income or to a special tax of 1 percent on the gross amount received from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus the interest which under section 22 (b) (4) is excluded from gross income, whichever is the greater. It is also proposed to exclude mutual marine insurance companies from the tax imposed by section 207 and to subject such companies to the tax imposed by section 204.

Section 207 (a) imposes a tax upon the income of mutual insurance companies other than life or marine. Companies with corporation surtax net income of $3,000, or less, and with gross amounts received from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest, of $75,000 or less, pay no tax under this section. Companies with normal-tax net income or corporation surtax net income of between $3,000 and approximately $6,000 are taxed under section 207 (a) (1) at a special notch rate of twice the standard rates. Companies with gross amounts received from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest, ranging from $75,000 to $150,000 are taxed under section 207 (a) (2) at a special notch rate of twice the ordinary rate of 1 percent. An additional notch provision applies to either of the above taxes where the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is between $75,000 and $125,000. The tax imposed by section 207 (a) is the tax computed under section 207 (a) (1) or 207 (a) (2), whichever is the greater. The amount computed under section 207 (a) (1) or 207 (a) (2) (A) is subject to the adjustment provided in section 207 (a) (3). The tax imposed by section 207 (a) (2) is not applicable to interinsurers or reciprocal underwriters.

The application of section 207 (a) (1), (2), and (3) may be illustrated by the following examples:

Example 1: The X mutual casualty insurance company for the taxable year 1942 has a corporation surtax net income of $3,500, and partially tax exempt income of $600, giving a normal tax net income of $2,900 and the gross amount of income from interest, dividends, rents, net premiums, minus dividends to policyholders, minus wholly

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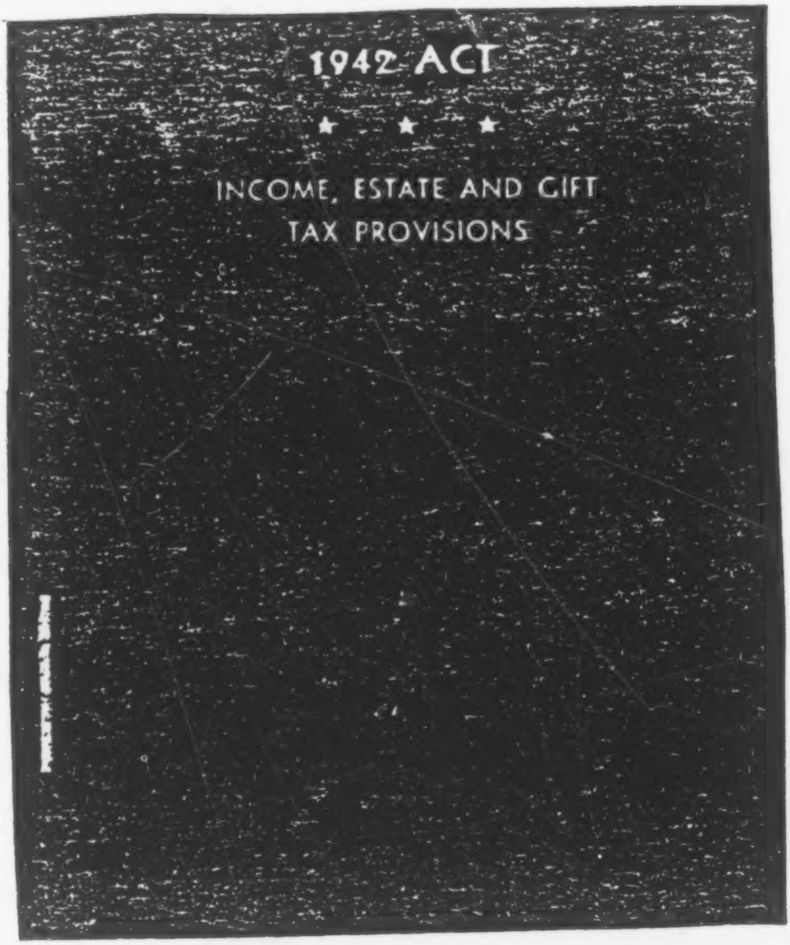

1942 ACT

★ ★ ★

INCOME, ESTATE AND GIFT
TAX PROVISIONS

1942 Act

SUBCHAPTER C—SUPPLEMENTAL PROVISIONS

Supplement A—Rates of Tax

[Supplementary to Subchapter B, Part I]

[Sec. 101]

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this chapter—

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) Fraternal beneficiary societies, orders, or associations, (A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual;

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

(7) Business leagues, chambers of commerce, real-estate boards, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual;

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes;

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder;

(10) Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 per centum or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses;

(11) Mutual insurance companies or associations other than life or marine (including interinsurers and reciprocal underwriters) if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000;

Exhibit D

[Sec. 205]

SEC. 205. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section 201, 204, or 207, to the extent provided in the case of a domestic corporation in section 131, and in the case of the tax imposed by section 201 or 204 "net income" as used in section 131 means the net income as defined in this Supplement.

Source: Sec. 205, Revenue Act of 1938.
No change.

[Sec. 206]

SEC. 206. COMPUTATION OF GROSS INCOME.

The gross income of insurance companies subject to the tax imposed by section 201 or 204 shall not be determined in the manner provided in section 119.

Source: Sec. 206, Revenue Act of 1938.
No change.

[Sec. 207]

SEC. 207. MUTUAL INSURANCE COMPANIES OTHER THAN LIFE OR MARINE.

Mutuals
other
than
exempt
originally
incl. f.c. are
except

[Sec. 207 (a)]

(a) Imposition of Tax.—There shall be levied, collected, and paid for each taxable year upon the income of every mutual insurance company (other than a life or a marine insurance company and other than an interinsurer or reciprocal underwriter) a tax computed under paragraph (1) or paragraph (2) whichever is the greater and upon the income of every mutual insurance company (other than a life or a marine insurance company (which is an interinsurer or reciprocal underwriter, a tax computed under paragraph (3):

(1) If the corporation surtax net income is over $3,000 a tax computed as follows:

(A) Normal Tax.—A normal tax on the normal-tax net income, computed at the rates provided in section 13 or section 14 (b), or 30 per centum of the amount by which the normal-tax net income exceeds $3,000, whichever is the lesser; plus

(B) Surtax.—A surtax on the corporation surtax net income, computed at the rates provided in section 15 (b), or 20 per centum of the amount by which the corporation surtax net income exceeds $3,000, whichever is the lesser.

(2) If for the taxable year the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policy holders, minus the interest which under section 22 (b) (4) is excluded from gross income, exceeds $75,000, a tax equal to the excess of—

(A) 1 per centum of the amounts so computed, or 2 per centum of the excess of the amount so computed over $75,000, whichever is the lesser, over

(B) the amount of the tax imposed under Subchapter E of Chapter 2.

(3) In the case of an interinsurer or reciprocal underwriter, if the corporation surtax net income is over $50,000 a tax computed as follows:

(A) Normal Tax.—A normal tax on the normal-tax net income, computed at the rates provided in section 13 or section 14 (b), or 48 per centum of the amount by which the normal-tax net income exceeds $50,000, whichever is the lesser; plus

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Sec. 207. Mutual Insurance Companies Other Than Life or Marine—Continued

(B) Surtax.—A surtax on the corporation surtax net income, computed at the rates provided in section 15 (b), or 32 per centum of the amount by which the corporation surtax net income exceeds $50,000, whichever is the lesser.

(4) GROSS AMOUNT RECEIVED OVER $75,000 BUT LESS THAN $125,000.—If the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 but less than $125,000, the amount ascertained under paragraph (1), paragraph (2) (A), and paragraph (3) shall be an amount which bears the same proportion to the amount ascertained under such paragraph, computed without reference to this paragraph, as the excess over $75,000 of such gross amount received bears to $50,000.

(5) FOREIGN MUTUAL INSURANCE COMPANIES OTHER THAN LIFE OR MARINE.—In the case of a foreign mutual insurance company (other than a life or marine insurance company), the net income shall be the net income from sources within the United States and the gross amount of income from interest, dividends, rents, and net premiums shall be the amount of such income from sources within the United States.

(6) NO UNITED STATES INSURANCE BUSINESS.—Foreign mutual insurance companies (other than a life or marine insurance company) not carrying on an insurance business within the United States shall not be taxable under this section but shall be taxable as other foreign corporations.

[Sec. 207 (b)]

(b) DEFINITION OF INCOME, ETC.—In the case of an insurance company subject to the tax imposed by this section—

(1) GROSS INVESTMENT INCOME.—"Gross investment income" means the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets to the extent provided in section 117;

(2) NET PREMIUMS.—"Net premiums" means gross premiums (including deposits and assessments) written or received on insurance contracts during the taxable year less return premiums and premiums paid or incurred for reinsurance. Amounts returned where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management shall not be included in return premiums but shall be treated as dividends to policyholders under paragraph (3);

(3) DIVIDENDS TO POLICYHOLDERS.—"Dividends to policyholders" means dividends and similar distributions paid or declared to policyholders. The term "paid or declared" shall be construed according to the method regularly employed in keeping the books of the insurance company;

(4) NET INCOME.—The term "net income" means the gross investment income less—

(A) Tax-free Interest.—The amount of interest which under section 22 (b) (4) is excluded for the taxable year from gross income;

(B) Investment Expenses.—Investment expenses paid or accrued during the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this subparagraph shall not exceed one-fourth of 1 per centum of the mean of the book value of the invested assets held at the beginning and end of the taxable year plus one-fourth of the amount by which net income computed without any deduction for investment expenses allowed by this subparagraph, or for tax-free interest allowed by subsection (b) (4) (A), exceeds 3¼ per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

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1924 Act

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[*(3) The term "cash dividends" includes dividends paid in interest-bearing scrip, if subject to tax in the hands of the distributees to the same extent as a dividend paid in cash.*]

CONDITIONAL AND OTHER EXEMPTIONS OF CORPORATIONS.

SEC. 231. The following organizations shall be exempt from taxation under this title—

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily inci-

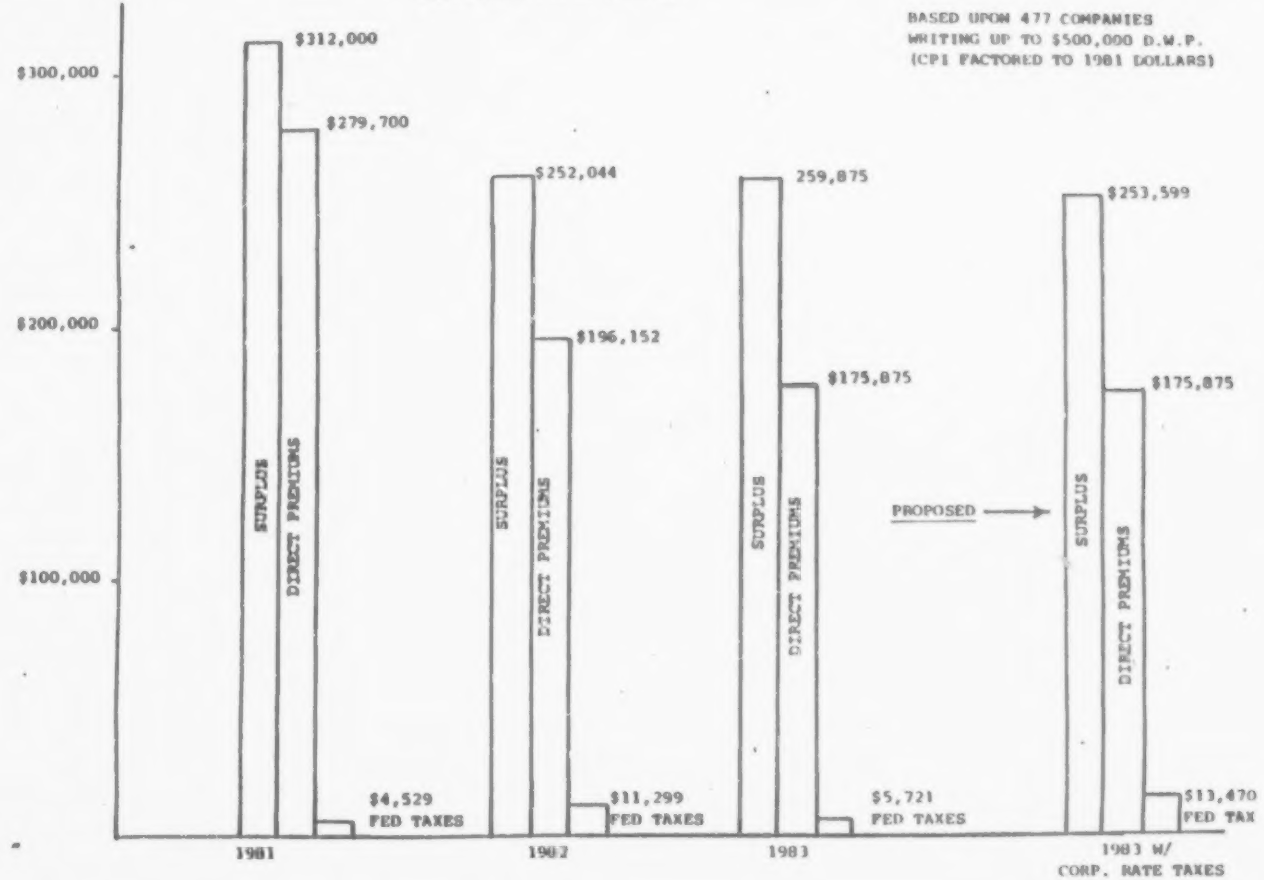
(10) [Farmers'] BENEVOLENT LIFE INSURANCE ASSOCIATIONS OF A PURELY LOCAL CHARACTER. FARMERS' or other mutual hail, cyclone, casualty, (76)[*life,*] or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, (77)[*or casualty or fire reciprocal or interinsurance exchanges,*] or like organizations; but only if (78)~~substantially all~~ *85 per centum or more of* the income consists of amounts collected from members for the sole purpose of meeting losses and expenses; (79)~~also benevolent mutual life insurance associations not operated for profit, whose business is purely local and wholly for benefit of its members;~~

(11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses;

(12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and

SMALL FARM MUTUAL COMPANY

BASED UPON 477 COMPANIES
WRITING UP TO $500,000 D.W.P.
(CPI FACTORED TO 1981 DOLLARS)



SMALL FARM MUTUAL COMPANY

Co. No. 10-0161

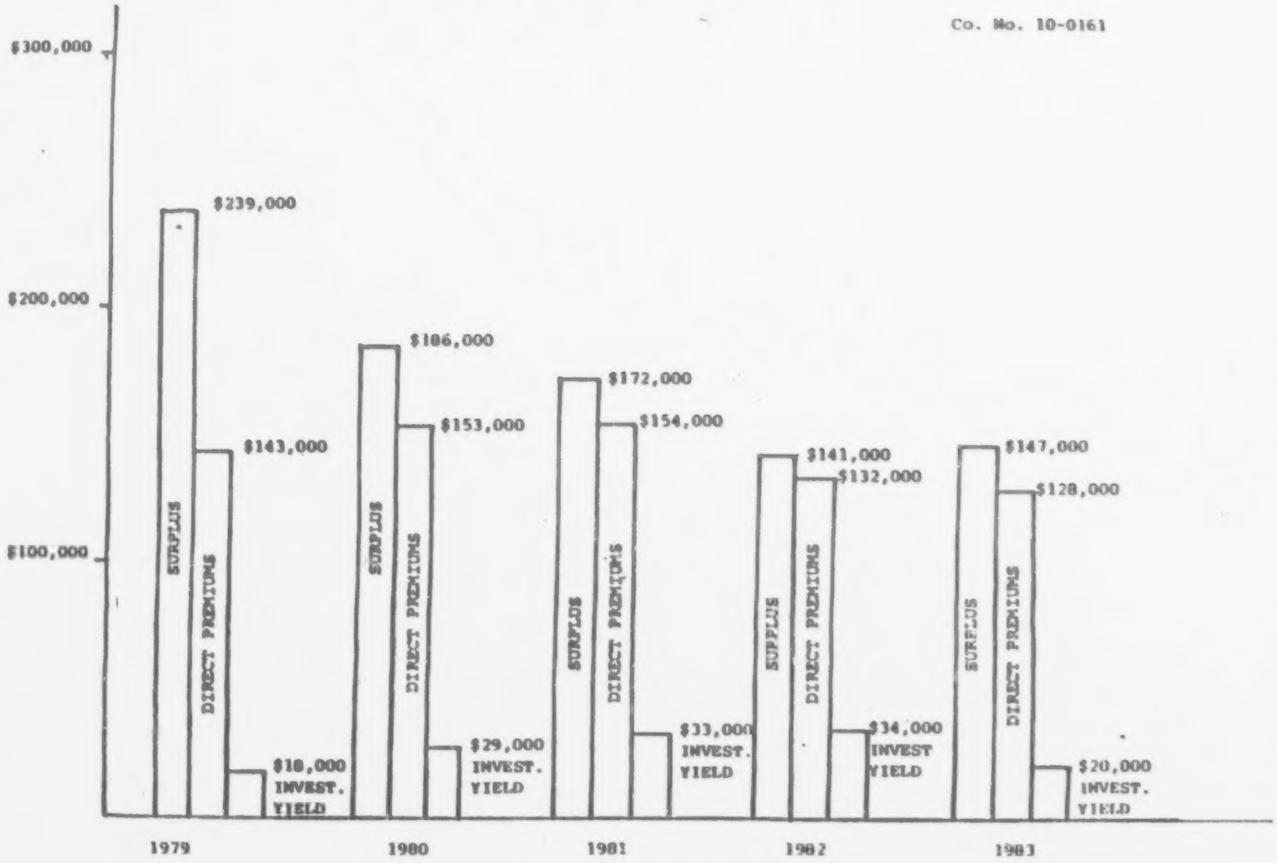


Exhibit G

PROPERTY AND CASUALTY INSURANCE COMPANIES

POLICYHOLDER'S DIVIDENDS
(LAST 000 OMITTED)

	1979	1980	1981	1982	1983
Stock	$607,311	$720,745	$883,535	$988,342	$1,095,750
Mutual	$509,512	$660,192	$669,075	$730,701	$814,821

These numbers were developed by applying the dividend ratio to the earned premiums for each group.

NET INCOME *(BEFORE DIVIDENDS AND FEDERAL TAXES)
AS A PRECENTAGE OF AVERAGE POLICYHOLDERS' SURPLUS

	1979	1980	1981	1982	1983
Stock	29.1%	27.3%	10.4%	15.8%	10.4%
Mutual	27.0%	28.3%	12.4%	17.5%	16.8%

*The Net Income figure is equivalent to Annual Statement Page 4, Line 18.

All figures were obtained from Best's aggregates and averages

STATEMENT OF BRADFORD W. MITCHELL, CHAIRMAN, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS, HARLEYSVILLE, PA

The CHAIRMAN. Mr. Mitchell.

Mr. MITCHELL. Thank you, Mr. Chairman.

My name is Bradford Mitchell. I am chairman and CEO of Harleysville insurance companies located in Harleysville, PA. I am also this year the chairman of the National Association of Independent Insurers, which is a trade organization of some 500 insurance companies; approximately 350 of them are stock companies; and approximately 150 are organized on the mutual basis.

NAII has filed a statement recording its feelings and objections with respect to all four of the administration's proposals.

I would like in my time allotted this morning, if I may, to refer to the QRA portion of those proposals. And, in particular, to the effect that that type of provision would have on the solvency of insurance companies and on State regulation of insurance companies.

The QRA presents a very new and novel method of reserving. It is based on the assumption that the correct reserve for an insurance company is not the full reserve required, but something less than the full reserve. This is conceptually wrong. Any method of discounting is conceptually wrong.

It will undercut the ability of State regulatory authorities to ensure the safety and sound financial condition of the insurance companies that they regulate.

This is exceptionally important when dealing with property/casualty companies because it is not just the stockholders of a particular company that will suffer if an insurance company goes under. It will be the policyholders and claimants of that company who will suffer the most from the insolvency of an insurance company.

Our Federal tax laws since 1921 have recognized that amounts held for the account of others in an insurance company are not the property of the insurance company, but rather the property of the policyholders and claimants for whom they are held. And, therefore, those amounts are not taxable to the insurance company.

Therefore, since the largest parts of the assets held by any insurance company are for the account of policyholders and claimants, they are the ones who will lose the most if a company becomes insolvent.

Gentlemen, I believe it is very important, and I believe a confusion has sometimes arisen, between property/casualty insurance companies and life insurance companies with respect to reserves. The reserves of property/casualty companies are for occurrences, losses that have already occurred. They have occurred. They may not have been paid yet, but they have occurred.

With respect to a life insurance reserve, as soon as you are insured by a life insurance company, it starts to set up a reserve because it knows you will die some day, and some day it will have to pay that amount. A property/casualty company sells its product before it knows what it costs it and it does not establish a reserve until the loss occurs. So we are talking about reserves for losses already in existence.

The fundamental solvency and safeguard of insurance companies through State regulation is the maintenance of adequate reserves.

It is easy for one to say that the Federal tax law will not affect State regulation, and the fact that the companies are taxed on a different basis as a result of their posted reserves required by the tax law does not affect what State regulators must do. But that is not as easily adhered to in the long run. If you have two different concepts, one by the Federal Government, one by the State government, eventually, one will arise as being the one dominant theory in concept. Financially marginal companies will insist upon that if it is good enough for the Federal Government, it is good enough for the State government, and reserves will be discounted and the solvency of that company will be in jeopardy.

In conclusion, the NAII objects to all of the proposals submitted by the administration and especially to the QRA proposal.

The CHAIRMAN. There are none of them that you like.

Mr. MITCHELL. None of them that I like, Senator. [Laughter.]

The CHAIRMAN. Not even the reduction in corporate taxation?

Mr. MITCHELL. I missed that one. [Laughter.]

[The prepared written statement of Mr. Mitchell follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

The National Association of Independent Insurers (NAII) is a voluntary, nonprofit trade assocation of property and casualty companies and an approved statistical-advisory organization. It was founded in 1945, following the enactment of the McCarran-Ferguson Act, which confirmed the propriety of state regulation of insurance.

NAII's founders sought enactment of state legislation permitting independence in pricing and policy forms, in the belief that vigorous competition would provide the insurance-buying public with the broadest protection at the lowest price. The soundness of that purpose is demonstrated by the fact that NAII has grown from the 21 charter members with a premium volume of $90 million to a membership of some 500 companies with a premium volume over $26 billion in 1984. NAII represents companies of all types of corporate structure—including stocks, mutuals, reciprocals and Lloyds—ranging in size from one-state writers to large multi-state companies. This large and diverse membership provides a strong voice representing the broadest range of views on major issues.

The Administration proposals would make the following changes:

1. Property and casualty ("P & C") insurance companies would be taxed as if they had discounted their reserves, using a new and novel "qualified reserve account" procedure.

2. Taxpayers (policyholders and claimants) would be permitted to deduct otherwise deductible losses regardless of whether they were insured.

3. Three provisions of current law providing certain deductions for mutual companies would be repealed. The stated purposes of these proposals is to "level the playing field" between stock and mutual P & C companies. In fact the proposals would upset the competitive balance which now exists.

NAII submits that all of these proposals are conceptually wrong.

The discounting proposal is not only wrong, but dangerous, as it would, if enacted, put the Federal government's imprimatur on concepts which, if they gain currency, will undermine the ability of state regulatory agencies to protect policyholders and claimants from company insolvency.

The QRA proposal would tax a P & C company on amounts substantially in excess of the company's economic income—a result which we understand the Treasury to concede. That would inflate the costs of P & C companies, with the greatest inflation occurring on the riskiest coverage that are even now difficult for the public to obtain. Those coverages will become even less available, and premium increases will be necessary across the board on all major coverages. The resulting turmoil will put further strain on solvency safeguards in an already distressed industry. In most other industries the soundness of a company's financial condition is a concern primarily of investors, but in the P & C industry it is policyholders and claimants who suffer most when insolvency occurs.

In the case of those proposals that would increase the tax of mutual companies, the ostensible purpose is to "level the playing field" between stock and mutual companies. However, the proposals would only undo leveling previously done. They would reverse parts of an earlier legislative package which Congress enacted in 1962 to "level the playing field." NAII represents both stock and mutual companies—over 350 stock companies, some 100 mutuals, and approximately 30 other types of companies. The NAII membership believes that, as a result of the 1962 legislation, the present playing field is relatively level, that the issue of level playing fields need not and should not be reopened in this industry and that the existing provisions with respect to mutual companies should not be repealed. The most persuasive proof that the provisions in issue do not create unneutral conditions lies in the fact that the stock companies are not complaining.

The nature of insurance and of property and casualty insurance in particular

In order to understand insurance taxation one must understand the special nature of insurance underwriting.

Insurance is an institution to permit the pooling of funds by policyholders in order to share risk. Over the years a variety of entity arrangements—partnerships, stock corporations, mutual companies, reciprocals, pools, etc.—have emerged to receive, hold and administer the pool of funds. But the essential nature of the function has remained the same in each case.

Property and casualty insurance is fundamentally different from life insurance. In property and casualty insurance policyholders pool their funds for the purpose of paying losses sustained by a few of them. The risk shared by pooling relates to economic loss currently sustained.

Life insurance is likewise a pooling device for risk sharing. But, unlike property and casualty insurance the life insurance risk relates primarily to a saving purpose, rather than to loss compensation. The holder of a life policy desires to save some specified amount for some future event. The most common event is death, but it may also be such events as retirement or attaining college age. The risk to be shared is that the policyholder will not live long enough (mortality risk) or stay well enough (morbidity risk) to put away the desired amount.

While the purposes—loss compensation and saving--are different, the essential concept in both cases is that the pool is held and nurtured as an asset belonging to the policyholders who have paid into it. Assets are released from the policyholder pool and become "income" to the administering entity, i.e., the "company", only when it is clear that they are no longer needed to satisfy the policyholders' claims. The mechanism for determining when assets are no longer needed is "reserving", which is carried out under explicit, well developed rules, regulated and closely scrutinized by state regulatory agencies. Premiums go into the pool in the first instance and earnings on those premiums go into the pool to the extent they are determined to be needed under the reserving mechanism.

Further, companies are required by state regulators to maintain prescribed levels of "capital and surplus" as a cushion against inadequacies that may develop in the pool. If the reserving mechanism determines at any time that the pool is deficient, the "company" is required to transfer additional amounts from its own "capital" and "surplus", i.e., from amounts originally paid in by its owners ("capital") and from amounts previously determined not to be needed and thus released from the pool ("surplus").

As in the case of banks and financial institutions, public regulation for solvency is required because the threat of insolvency is a threat to the public at large, not just to the owners of the company. The fundamental solvency safeguard is the maintenance, at all times, of adequate reserves and capital and surplus. That adequacy depends upon common acceptance of standards of adequacy by the industry and the public and upon the vigilance and ability of state regulators to enforce those standards when necessary.

Operation of the tax rules

Tax rules applicable to property and casualty insurers follow the general concepts described. To the extent premiums and income from investing premiums are needed for policyholder purposes, they must be set aside in the pool for those purposes. This is required by the insurance regulators of every state. To the extent that these items are being held for the account of others and they have not yet inured to the company's benefit, the company is not yet better off, and, accordingly, it has no income—taxable or otherwise. When it is clear that they are no longer needed and they are released to the company, they become income to it, but not before. It is at that point that they are taxed.

Specifically, premiums that relate to future periods ("unearned premiums") are still needed and are therefore held in "reserve" and not subjected to tax until "earned". Premiums that relate to the current or prior periods (i.e., "earned premiums") are still needed to the extent required to take care of losses that have already occurred and, to that extent, are not included in income. That is a proper result for two reasons: because there is no reason to tax amounts which the policyholders have set aside to pay out on their own behalf, and because real economic losses have already occurred. In practice, all or all but a small fraction of earned premiums are used to pay losses that have already occurred at the time the premiums are earned, and are, accordingly, never released to the company's own account. However, to the extent that premiums earned at the end of any accounting period exceed the losses that have actually occurred, the excess is income to the company and is taxable.

Investment income involves somewhat different considerations because, unlike premiums, it is not simply a transfer from the policyholder to be used for particular purposes, but is an amount of newly earned income. Investment income is accordingly taxed currently, as earned. However, to the extent that premiums are insufficient and investment income is needed to offset losses that have actually occurred, the investment income is offset by the excess of these losses over earned premiums.

It is important to keep in mind always that the amounts of premium or investment income which are "needed" and must be retained in the pool are losses growing out of events that have actually already occurred, as distinguished from losses from events which may occur at some future date. Thus the term "reserve" in this property and casualty loss context does not include provision for future events, although in other business and insurance contexts, including life insurance, the term "reserve" is often used to describe a present provision for a future event.

The proposal that would have the largest and most adverse impact on the P & C industry involves the concept of discounting company reservers.

As explained above, reserves are the mechanisms by which a company excludes from its receipts the amounts it is required to hold and use for the benefit of policyholders and claimants. As the reserve amounts are held, so to speak, "in trust" for others and may not be used for the company's own purposes, they do not constitute "income" to the company.[7]

The basic concept at issue is whether, in computing its income, a P & C company should reserve (i.e., exclude from its gross receipts) the full amount required to discharge the obligations to others, or whether it should reserve a lesser amount, equal to the "full reserve" reduced (i.e., "discounted") by an amount reflecting the investment income it expects to earn on the reserves in the interim period before the funds reserved will actually have to be paid out.

In order to discuss clearly the dicounting of P & C reserves, it is important to be clear about terminology, as the terms "discount" and "discounting" are used differently in different contexts. They can, for example, refer to any reduction in an amount—as in the case of a retailer who "discounts" prices. In financial computations, they usually refer to reductions based on the income value of funds over some future time period, i.e., reductions calculated with reference to some assumed rate of earnings over some assumed future time period. The rate of earnings assumed may be an after-tax rate or a pre-tax rate, depending on the context. Perhaps the most common use of the term in a financial context is in connection with so-called "discounted cash flow analyses", which compute the "present value" of payments to be made or received in the future. In that context the amount of the "discount" changes as the "present" date moves closer in time to the date of payment or receipt and a pre-tax rate is normally used.

For purposes of the discussion that follows, the terms "discount" and "discounting" will be used to refer to any reduction based on the income value of funds over time, and not to any particular method of computing that value or to the points in time at which the value is computed. It will be seen as the discussion moves forward that the Administration proposals and the GAO proposals involve different discounting techniques, that the GAO proposals are based on the traditional methods for computing changing present values and that the Administration proposals rest on different discounting concepts, which are sufficiently new and novel that they are not even thought of as "discounting" by many persons accustomed to working with conventional present value computations.

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[7] Note that even the Administration's proposal assumes that the bulk of a P & C company's receipts do not constitute income at all. That is normally the case for a party whose receipts are received, not for its own use, but for the account of others. E.g., receipts by a bank from depositors are not an item of gross income, nor are receipts by a trustee from a settlor. Thus, Code section § 832, which defines gross income of P & C companies, excludes from gross income the amount of the taxpayer's reserves for losses and loss expense and unearned premium. Although these reserves are technically "exclusions" from income rather than "deductions," the arithmetic result is the same and the terms are commonly used interchangeably.

The Administration proposal would tax P & C companies "as if" they discounted their reserves for losses, loss expense and unearned premiums. It would not actually require reserves to be discounted, but discounting would be the standard of reference for measuring tax liability and if the company did not discount in the prescribed way in the first instance, subsequent tax remittances would be adjusted to put it in the same position as if it had. As indicated, the method of discounting proposed as the standard of reference differs from the method most commonly used (ie., in discounted cash flow analyses) in two major respects: (1) it uses an after-tax discount rate and (2) it does not permit deductions for increases in the reserves as the amount of discount decreases (and the present value increases) with the passage of time, with the result that the full loss amount is never deducted.

The Comptroller General has also issued a report on the taxation of P & C companies. While it, too, recommends the discounting of loss reserves, it disagrees with the Administration as to the method of discounting, finding the Administration proposal both erroneous and too complicated. It would use the traditional discounting procedures used for cash flow analysis, based on a pre-tax discount rate and providing additional deductions as the dwindling discount caused the reserve to increase, with the result that there would be, ultimately, deduction for the entire amount of the losses.

Both discounting methods would increase the tax liabilities of P & C companies. As the GAO method provides ultimately for deduction of all actual losses and the Administration method does not, the GAO method would increase tax liabilities in substantially lesser amount than the Administration method.

NAII submits that discounting, under either method, is erroneous. Both the Administration proposal and the GAO proposal rest upon mistaken notions as to the nature of the P & C company's function. Further, there is no conceivable way that the Administration method can be justified as properly measuring the economic income of a P & C company, as an entity. As will be shown later, the Administration method would double tax a substantial portion of investment income and would impose tax even in situations where the company clearly has an economic loss. The Administration proposal can be (and is) defended only on the argument that some portion of the amount ultimately paid to injured parties represents investment income to them which, since Congress is unwilling to tax it there, should be collected from the P & C company.

Discounting is erroneous, whatever the method

"Discounting" of property and casualty loss reserves [8] would be wrong, whatever the discounting method used.

A P & C company receives funds for the purpose of reimbursing losses. Loss reserves reflect the amount it is required by law to hold, for the account of others, in order to cover losses that have already occurred.[9] The present system—for legal and financial purposes, as well as tax purposes—is, and always has been, to require the company to hold for the account of others (i.e., to "reserve") the full amount of the losses. The public, whose funds it is that have been entrusted to the company to hold, is entitled to have the funds held available for the purposes they were paid in—and not for the P & C company's own use—to the full extent of the losses that have occurred. If the P & C company were permitted to dip into those amounts, on the grounds it wold replenish the funds with amounts it expects to earn later, the risk to the public is obvious. (There is risk to the public even with full reserving, as the estimated amounts of loss are subject to considerable uncertainty and hard-pressed companies may be tempted to shade the estimates downward, thus releasing more of the receipts for their own use.)

Thus the key features of the present system of full reserving are (1) that the company is not legally entitled to take, as its own income, that portion of its receipts which is equal to the full amount of the estimated loss, and (2) that investment income will be treated as taxable income when it is actually received.[10]

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[8] The Administration proposal would also apply discounting concepts to other P & C reserves. The discussion here deals with loss reserves, but the analytical issues are the same for all the reserves.

[9] It is important not to confuse this situation, where the economic loss has already occurred, with the situation in other industries where provision often called "reserves", is made for probable future losses or expenditures. Where, as here, loss has already occurred, it should be accounted for in full in computing taxable income when it occurs. If it is not, taxable income in the system as a whole will exceed economic income.

All methods of discounting, on the other hand, rest on the premises that (1) the company need not be treated as holding for others the full amounts required to pay the losses, (2) but may reduce the amounts so held by the amount of expected future investment income. The result of any method of discounting is to reduce the amount of loss excluded from income, and the amount of that reduction is the value of future investment income. thus, while the result can be described as a reduction in the amount of loss, that is simply a way of including in taxable income, in advance, the value of projected future investment income. (The extra twist in the Administration proposal is that while the tax liability for investment income would in economic effect be incurred in advance of the income, the taxpayer can elect to remit a part or all of the liability at a later date, provided that it augments the later remittance by any investment income it earns as a result of delaying remittance.)

Discounting is wrong for P & C companies because the companies have no true economic income upon receipt of funds which they are legally required to hold for others, not for their own use, and beacuse investment income should not be treated as taxable—to anyone—inadvance of the time it is earned.

To illustrate these principles, assume that a P & C company receives funds for the purpose of reimbursing an accident, that the accident occurs and that it is determined that the amount of the economic loss for which reimbursement will be required is $100. The issue is whether, in determining the amounts available to it as income, the company should exclude from its gross receipts the full $100[11] or whether it should reduce (i.e., "discount") the $100 by $x, where x reflects investment income expected to be earned on the reserve funds before they are required to be paid out in reimbursement. Reducing the amount of receipts that are excluded in computing income is, in effect, increasing the amount of income. Thus, the effect of discounting the reserve by $x, where x represents the value of expected future investment income, is to tax immediately the value of that expected future income. It will be observed that if the value of the expected future investment income, $x, is taxed before the investment income is actually received, then if and when that income is actually received, at least $x must somehow be excluded from tax in order to avoid taxing the same income twice. It will be seen later that the traditional discounted cash flow type of discounting does at least avoid that double taxation, but that the method of discounting implicit in the Administration proposal does not.

In sum, the discounting of P & C loss reserves would crate major distortions in the taxation of economic income: liability for tax on future investment income would be treated as arising before the investment income arises, a result given effect through the disallowance of a part of the true economic loss that has occurred.

Discounting would seriously undermine the financial integrity of State regulation and the operating framework of the P & C Industry

Exhibit B, attached, is a resolution of the National Association of Insurance Commissioners (NAIC), adopted in June of this year. It reflects the view of the regulators—identical to that of NAII and the P & C companies regulated—that the proposed changes in reserving for tax purposes will undermine efforts to "preserve the safety and soundness of insurers".

The threat which the Administration proposals pose to safety and soundness arises from the fact that they rest on concepts and assumptions inconsistent with those underpinning the existing accounting and regulatory rules. The concept of discounting strikes at the primary objective of all operating and accounting procedures for property and casualty insurance: financial integrity and meticulous responsibility to policyholders and claimants, whose money it really is that the companies are receiving, reserving and disbursing.

The basic assumption underlying the longstanding system of P & C insurance accounting is that when funds are paid into the company in the form of premiums, those funds and the investment income on those funds must be held inviolate for third parties, namely, the policyholders who paid the funds in as premiums and the injured parties having claims under the policies. The hope or expectation that the funds held in reserve will earn income tomorrow does not justify the company's reserving today for less than the full liability.

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[10] It should be noted that life insurance reflects entirely different factors. Unlike property casualty insurance, it involves no present economic loss that reduces income in the economic system. Life insurance is a savings device, subject to future uncertainties. Discounting there is an arithmateical technique for determining how much of the current payments the company should reasonably be required to hold for the account of the policyholder.

[11] If $100 of premium were paid into a formal trust for the purpose of reimbursing a $100 loss to the grantor or other beneficiaries, and the trustee had no right to any of it, no one would suggest that some part of the $100 was income to the trustee. The regulatory rules governing P & C insurance are essentially specialized trust rules.

Discounting, as indicated, is based on a contrary concept. The discounting concept is that a company need not hold a full reserve, but only a discounted reserve, and that it is entitled to take as income for itself, from the monies paid in by the policyholders, the amount which it hopes to earn on those amounts in the future. In short, discounting is based on the premise that the full reserving presently required is excessive.

In the abstract, discounting for tax purposes need not dictate discounting for financial or regulatory purposes. But, in practice, tax accounting rules create irresistible pressure for other rules to follow and establish conceptual approaches that take root in other fields where they do not belong.

Regulation to ensure solvency is presently entrusted to state regulatory agencies. The ability of the states to regulate in a way that ensures solvency would be greatly hampered if any discounting method should be enacted or endorsed. It is easy to say that the regulators could continue to enforce the rules requiring full reserving, no matter what is done for tax purposes. But reality is otherwise. State regulation does rest, of course, upon specific regulatory rules; but the rules, in turn, rest upon common acceptance of underlying concepts. If a concept is adopted which holds that a larger part of the aggregate income from premiums and investments belongs to the company as its income, the other side of the coin is that a smaller part of that aggregate income represents the reserves against which claimants and policyholders have rights, Financially marginal companies will press for such rules, administratively and in court. Regulators will find it difficult, if not impossible, to resist income concepts that are endorsed by the Federal Treasury, and policyholders and claimants will have less protection. The regulators' ultimate enforcement sanction is to take over the company, but whether they have the right to do so will depend upon whether the company is insolvent which, in turn, will depend upon the key question of whether its true liabilities are to be measured on a discounted or undiscounted basis. One need only look to recent insolvency actions, including the many that involve savings and loans institutions, to see that litigation over the concepts applicable to valuing liabilities is a serious and constantly recurring problem.

What really is at stake is the erosion of the principle that the company has no right to use as its own (and has, to that extent, no income) those amounts which are required to pay in full the claims known presently to exist.

Erosion of that principle will seriously undermine financial integrity and jeopardize the resources not only of the companies; but also of millions of policyholders and claimants.

Discounting—The QRA proposal in particular

The fundamental premise of the QRA proposal is that the proper deduction for a loss is a discounted amount, computed at an after-tax discount rate for the period between the time the deduction is taken and the date the loss is actually paid, and that no additional deduction would be allowed notwithstanding that an amount greater than the deduction must ultimately be paid.

The deduction described becomes the standard of reference. The company would be permitted to deduct a different amount in the first instance—including, if it should choose to do so, the full reserve deductible under present law. But if it deducts an amount greater than the "proper" discounted amount, it would incur an additional tax, at a later date, to put it in the same position as if it had originally deducted only the discounted amount. Thus, while the company would not technically be required to use the discounted reserve in the first instance, it would in the end be taxed as if it had.

The QRA would tax investment income twice.—The proposal requires the taxpayer to pay tax, either initially or later, as if its reserves were discounted. As in all methods of discounting, the effect of the proposal is to impose tax liability as if investment income arose in advance of the time it is received by the company.

Under QRA, the company's taxable income would include a part of its investment income twice. It would include, as at present, all the investment income actually earned at the time it is earned. In addition, it would re-include (in effect, in advance) that portion of the investment income allocable to the QRA reserve, reduced by the tax allocable to that income. (See Exhibits A-1—A-4.) Tax exempt income (i.e., on state and local bonds) would be taxed on only the second, the "re-inclusion" component—i.e., it would continue to be exempt from tax when actually received, but an amount equal to the value of the "after-tax" portion of such exempt income would be included (in effect, in advance) in taxable income.

The adverse effect of QRA is thus twofold: it taxes a part of investment income in advance and it taxes the same amount again when the income is actually received. The result is to impose a tax burden that is significantly higher for P & C companies than for other companies and is unfair to the P & C insurance industry.

Exhibit A illustrates, with several examples, how it is that the QRA taxes a portion of the investment income in advance and then taxes all of it again when actually earned. The exhibit demonstrates how the ultimate liability is adjusted so that the company always ends up with the same amount regardless of what it claims as its original contribution to the QRA. It further demonstrates that there would be tax owing even in many situations where there was an actual economic loss—thus dramatically illustrating that the system would tax more income than economically exists.

The QRA would seriously undermine the financial integrity of state regulation and the operating framework of the P & C industry.—Any system of discounting, as explained earlier, is based on the concept that full reserving is excessive and that amounts received in excess of the discounted reserve are income to the company. That is, also, the basic premise of the QRA system.

The Administration contends that QRA is not a system of discounting because the company is free to take its initial QRA reserve deduction in an amount equal to the full reserve. That is mere quibbling with words. The operative fact is that under QRA a discounted reserve is the standard of reference for computing tax and the company would be ultimately taxed as if it had discounted, no matter what deduction it originally took. It is the concepts involved—not what is initially reported in the tax return—that poses the threat to solvency safeguards and policing procedures. If the Federal government endorses the concept that the company does not really have an economic liability for the full reserve, that concept will ultimately prevail. State statutes that provide otherwise, or seem to provide otherwise, will be vulnerable, as are all statutes that rest on assumptions that become inconsistent with what the public generally perceives to be true, and the ability of regulators to insist on full reserving will be compromised and the temptation to relax it enhanced.

It is important, too, to keep in mind that if, under QRA, the company reflects in its QRA account deduction any amount greater than the discounted standard of reference amount, it may lessen the amount of tax it must remit immediately, but the liability is nonetheless there and will be augmented by earnings imputed to it and remitted at a later date. Notwithstanding that remittance of tax is postponed, the liability and the periodic augmentations will reduce its capital and surplus account immediately. The amounts of liability and augmentation must be estimated, because they will depend on future investment returns and future settlement events. These new and uncertain liabilities, too, will need to be policed by state regulators as they will substantially affect the companies' cushions against insolvency. Thus, the system, if enacted, would impose new and uncertain burdens and complexities on the solvency regulators.

Other adverse consequences of discounting

Disadvantage with respect to foreign insurers.—Discounting would seriously disadvantage the domestic P & C industry in its competition with foreign insurers. P & C insurance is a highly portable international business. No large plant or equipment is necessary. Marketing can be done through independent brokers and agents. A very substantial amount of the insurance of United States risks can be and already is placed across national borders with insurers operating under more favorable tax regimes. The discounting of reserves and its accelerated taxation of future income would substantially increase the costs of domestic insurance and disadvantage domestic insurers in their already fierce competition with foreign insurers.

Complexity and controversy.—Discounting of loss reserves for tax purposes—whatever method might be adopted—would be a nightmare to administer. Conventional discounting would require the determination of proper discount rates (which would never be clear cut and would always be changing) and of the estimated future payout schedule of the losses (which would necessarily be judgments, based on an array of statistical data).

The administration claims its QRA proposal would eliminate some of those complexities, and it would—but at the expense of new and different complications. The QRA method is highly theoretical and would require complex recordkeeping and computations. It would require, for example, "rate of return" calculations which sound simple, but which would in fact be subject to extensive judgmental cost allocations. Similar computations in the life insurance area proved so controversial and so erratic among companies, that devising a new system that eliminated the necessity for them was a widely advertised accomplishment of the 1984 revisions of the life insurance taxation rules.

Either method of discounting would, in short, require judgments and estimates that go beyond the competence of ordinary auditors to police. New layers of experts would be required at the companies, state regulators and the IRS. Smaller companies would have to go outside for expensive and time consuming consultant and service arrangements. Endless controversy would be the sure result.

Increased premiums and restricted availability of coverages.—QRA would impose substantial additional tax costs on P & C companies, payable either immediately or later. P & C companies must cover their costs, including taxes, and earn a fair return on investment in order to stay in business. Accordingly, if QRA is enacted, P & C companies will seek to increase premiums to cover the substantially increased costs it would impose. If they cannot cover costs on particular coverages they will discontinue writing them. When the increased cost is non-deductible—as in the case of the cost of increased income tax—the premium increase must be a "grossed-up" amount. Under a 46% tax rate, in order to cover $1 of increased tax it would be necessary to raise premiums by $1.85.

If QRA were to impose substantially different costs on the same coverages written by different companies, the additional costs might not be passed through in the marketplace, as companies with the higher costs would be forced to meet the prices set on the same coverage by companies with lower costs. But that is not the case here, the increment in cost for similar coverages would be fairly uniform across different companies. Raising premiums, however—particularly when it involves a large increase—is always a difficult and disruptive, job for sellers, as they never know just what their competitiors will do and must balance the risk of losing market share (if they raise prices immediately and their competitors lag behind) against the risk of losing money (if they fail to cover increased costs with increased premiums). As a result, there will be turmoil as the marketplace moves to new equilibrium prices, and there will be inevitable casualties.

A. M. Best Company, the highly respected insurance financial rating organization and authority on P & C insurance, indicates that at current tax rates premiums would have to be increased by an average of 11 percent to cover the added tax burden. In liability lines of insurance, the increase would be higher. It is estimated that medical malpractice would be increased 32 percent, general liability by 24 percent and workers' compensation by 15 percent. It has also been estimated that if the tax rate is reduced to 33%, an overall premium increase of 8% would be required.

The necessity to increase premiums will exacerbate the problems the public is already having in obtaining many kinds of coverage. Those problems are presently greatest on the riskiest, longest settling coverages like medical malpractice and general liability, on which the need for premium increases will, as indicated, be greatest. Many companies have already withdrawn from writing this business. The need to radically increase premiums will accelerate the withdrawal process and will, in any event, make the coverage so expensive for many small businesses that they will be compelled to do without.

Withdrawal from the business will be further impelled by the effect of QRA on companies' capital and surplus accounts. P & C companies must maintain a reasonable relationship between their capital and surplus and the premiums they write. QRA would substantially increase liabilities (whether payable immediately in the case of discounted deductions or payable on termination of the QRA account in the case of initial deductions equal to the full reserve) and would, accordingly, reduce capital and surplus. As capacity is already strained, further surplus reductions in amounts so substantial will necessarily mean that for many persons and businesses, particularly small businesses, certain coverages may become prohibitively expensive or simply unavailable.

Difference from life insurance

None of the foregoing analysis with respect to discounting applies to life insurance, where entirely different factors are involved. The life policyholder typically makes periodic premium payments, which, when compounded at some rate of interest for a number of years, will add up to the face value. The interest compounded for the policyholder's account (the so-called "inside buildup") is excluded entirely from tax, although it is in fact income in the tax system as a whole, not offset by losses of any kind. It would be possible—and easier for the layman to understand—simply to compute the compounded interest element each accounting period and exclude it from taxable income. However, for simplicity in dealing with policies in bulk and to facilitate periodic adjustments in the interest assumptions, that is not done. Instead the insurer takes the target savings amount (face amount) and subtracts from it future premiums scheduled to be paid, plus estimated future investment income to be earned on accumulated balances. That is done by solving mathematically for the number which, when augmented by the future premiums and investment income, will equal the face amount. Mathematically that technique is known as "discounting" the face amount—i.e, determining the amount which is required now in order to grow to equal the face amount at some future date, assuming some specified interest rate. Discounting in this context is a mathematical shortcut to back out the investment income already compounded on the amounts deposited by the policyholder, so that the amounts can be set aside, relieved from tax, and accumulated for the policyholder.

None of that is involved in casualty insurance, as the casualty policyholder is not entering into a saving transaction and is not entitled to have interest compounded on his account. The casualty policyholder is entitled only to have his economic losses paid, and it is the loss, not an investment computation, that determines the amount he is entitled to have set aside. The amounts so set aside produce no tax, not because they are specially exempt, but because they are offset by real, economic losses.

The mutual policyholder dividend proposal

Both stock and mutual P & C companies are currently allowed to deduct dividends which are returns of excess premiums to policyholders in their capacity as such. The Administration proposes that the deduction for policyholder dividends allowed mutual P & C companies be reduced in a manner similar to the way in which the deduction for policyholder dividends allowed mutual life insurance companies is reduced under current law. The expressed purpose of the Administration's proposal is to eliminate a competitive advantage which mutual companies allegedly enjoy over stock companies as a result of the full deductibility of policyholder dividends.

Policyholder dividends are amounts paid by casualty insurance companies to policyholders as returns of excess premiums. In essence, they are premium refunds. Policyholder dividends developed as an outgrowth of requirements that premium rates be approved by state insurance regulators. This regulatory requirement made it difficult for P & C insurers to adjust the price of their products up front to reflect their costs of doing business. By refunding excess premiums as policyholder dividends, P & C insurance companies—both stock and mutual—have maintained the flexibility necessary to price their products to reflect market conditions.

A provision similar to that proposed by the Administration was enacted in connection with the recent revisions in life insurance taxation. Apparently, the concept was carried over to the P & C insurance context without stopping to consider that the facts and concepts underlying property and casualty insurance are entirely different from those present in life insurance. However appropriate the theory may be (it was very controversial) in the life insurance context, it has no proper application for property and casualty insurance. In the life insurance context it was argued (pro and con) that such a provision was required in order to eliminate a competitive edge enjoyed by mutual companies. There is simply no such edge in the property and casualty context. The most eloquent evidence of that fact is that the stock P & C companies are not complaining. They are, in fact, united with the mutuals in the position that this proposal is wrong.

Unlike the life insurance industry, P & C insurers typically write many different lines of coverage—e.g., automobile, homeowners, liability, workers compensation. Policyholder dividends are paid with respect to some of the coverages, but not with respect to others. Some companies pay policyholder dividends in some states and not in others, based on their experience in the various states on particular lines of insurance. Since some policyholders are paid policyholder dividends while others are not, depending on which types of insurance coverage they have purchased from the P & C company, it is evident that policyholder dividends are not used as a vehicle to distribute earnings to policyholders in their capacity as owners of the company.

Moreover, substantial policyholder dividends are paid by both stock and mutual P & C companies. For example, of the $2,079 billion in policyholder dividends are paid in 1984 by P & C companies, stock and mutual companies each paid about 50 percent.

More than 80 percent of all policyholder dividends are paid with respect to commercial policies (including workers compensation). These dividends do not result in a net revenue loss to the Treasury because, unlike most dividends on life insurance, dividends on business related to P & C insurances are included in the policyholder's income. The remaining 20 percent are refunded premium to individuals who did not deduct the premium for tax purposes in the first place.

In some, the proposal does not address an existing unfairness. On the contrary, if enacted it would create an unfairness. It would impose a new tax and an extra penalty on mutual companies, leaving many of the companies with higher costs and, as a result, with a noncompetitive pricing structure.

The PAL account

Mutual property and casualty insurance companies are allowed a special deduction for amounts added to their protection against loss ("PAL") accounts. The purpose of this deduction is suggested by the name of the PAL account: to provide mutual companies with a cushion from which extraordinary losses can be paid.

The Administration's proposals would eliminate for mutual companies the "PAL account" provision. That provision was enacted in 1962 in order to "level the playing field" for stock and mutual companies.

The purpose of the PAL account is to assist mutual companies to be better able to handle extraordinary losses. The necessity for having such an account arises out of the very nature of mutual insurance companies. Unlike stock insurance companies, mutual companies generally lack access to outside capital infusion and must rely, for a safety cushion, on the accumulation of funds which would otherwise be returned to policyholders. This accumulation thus serves the same purpose as the capital of stock companies. The deferral of the tax on such an accumulation compensates mutual companies for the lack of capital and access to capital, and it is an important tool for eliminating or diminishing any competitive advantage which stock companies might enjoy as a result of their capital and capital-raising potential.

The amounts involved are small from the Treasury's point of view in the aggregate, but are extremely important for the individual small companies involved. NAII surveys of its member companies show that the PAL deduction has served the purpose for which it was intended. More importantly, the PAL deduction has allowed many smaller companies which have suffered underwriting losses in recent years to remain solvent.

Here again, the best evidence that the PAL account does serve a useful leveling purpose lies in the fact that the stock companies have not found that the provision places them at a competitive disadvantage vis-a-vis mutual companies. They are agreed with the mutual companies that the provision should be retained.

Special small mutual P & C provisions

The Administration proposes to repeal special tax exemptions, rate reductions and deductions which are currently provided for certain small mutual P & C insurers. These provisions, which have been in the Code since 1963, currently exempt mutual companies with gross income of $150,000 per year or less. Companies with gross income exceeding $150,000 but not exceeding $500,000 may elect to be taxed only on investment income. Other provisions lower the tax rate on investment income or taxable income in specified circumstances.

The rationale provided for this proposal is that current law gives these small companies a competitive advantage vis-a-vis stock companies and larger mutual companies.

This proposal would impact severely on approximately one thousand extremely small mutual P & C insurers, most of which have their origins in cooperative ventures in particular localities or farm communities throughout the nation. These companies play a significant role in providing insurance coverage in small communities and rural areas where coverage is frequently not otherwise available. The revenue impact of these provisions is miniscule from Treasury's standpoint but of profound significance to the individual companies involved. Neither larger mutual nor stock P & C insurers have complained that the provisions of current law give small mutuals a competitive advantage. Therefore, there is no need for change.

Economic conditions in the P & C industry in the past several years can best be described as near catastrophic. Last year the industry as a whole had a net loss. It was the worst year since the San Francisco fire.

Grim economic conditions are not necessarily a reason for rejecting change, but they are a compelling reason for exercising caution and making careful inquiry before abandoning systems that have worked well for the past century.

And they are surely a defense against the suggestion—sometimes advanced—that every industry should contribute substantial revenue to the "tax reform" effort, regardless of the merits of the changes proposed for them.

The fact is that income tax payments by P & C companies have been down very recently primarily because profits have been down. They have also declined, relatively, because of some special factors arising out of the volatility of inflation and interest rates, which impact P & C operations in a special way. When all of these factors are understood, it will become clear that P & C companies have indeed paid their share and that allegations to the contrary arise from the failure to understand the underlying economics of the industry.

The impact of inflation and competition

Over the last decade, rampant inflation has radically changed the property and casualty insurance business.

As already noted, in property and casualty insurance, policyholders in effect contribute premiums to a pool to pay for economic losses sustained by individual policyholders and for the costs of administering the pool. The premiums are invested during the period between their receipt and their payout, and the income from those investments is also applied to the payment of losses, if needed. The premiums and investment income not needed for the payment of losses and expenses are released to the insuring entity as its profit, but only when it is clear that they will not be needed. Generally, most of the premiums (in recent years, all of the premiums) are used to pay losses and expenses, so that all but a small fraction of the total cash flows are flows for the account of policyholders rather than for the account of the insuring entity itself. The insuring entity thus operates under concepts very much like those applicable to a trustee.

Under these circumstances, the amount of premiums required to be collected is directly affected by the amount of the investment income which will be earned on the premiums before they are required to be paid out. If there is low investment income, premiums must be higher; if there is high investment income, competition will force premiums lower.

Fifteen years ago, before inflation exploded, premiums were sufficient in most P & C companies to cover all of the losses and all of the cost of administering the losses. In technical terms, the percentage which losses and expenses are of premiums is known as the "combined ratio". A combined ratio of 100% means that premiums are sufficient to cover losses and expenses exactly. A combined ratio of less than 100% means that the amount of premiums is somewhat greater than the amount of losses and loss expenses, which means, in turn, that a part of the premiums themselves and all of the investment income on the premiums are left to compensate the insurance company for other costs, including the cost of supplying additional capital.

There is nothing magical, of course, about whether premiums alone cover all, not quite all, or more than all of the losses and expenses. Managements set premiums (unless constrained by state regulatory agencies or competitive conditions) at a level such that the premiums, when added to earnings on the premiums, will cover losses and expenses and provide a reasonable return on investment. Vigorous competition among thousands of underwriting entities ensures that premium prices will be kept at a level sufficient to pay expenses and provide a reasonable return, but no more.

There may be no other industry in which the results of an intensely competitive marketplace have been so visible. NAII owes its creation and much of its subsequent success to its crusade in the 1940s and 50's to change regulatory practices so that individual companies could price their premiums competitively, based on their own costs. Our largest members today owe their market positions to the existence of a highly competitive marketplace in which they won market share by cutting costs, and then charging the most attractive (i.e., lowest possible) premiums. And many of our smaller members owe their ability to break into the business and become successful to that same thing—the ability to price compete.

Virulent inflation has had two major effects on this competitive process and on pricing, in particular.

The first effect has been with respect to losses, which have steadily grown larger and less predictable with inflation. Losses have inflated significantly faster than prices generally, which has tended to make premiums chronically insufficient.

The second effect of inflation has been that earnings from invested premiums have become a radically larger portion of income. Double digit inflation brought double digit interest rates. That may at first blush seem an advantage to the industry, but it was not. The radical increase in interest rates caused a massive decrease in the value of asset portfolios invested earlier at lower interest rates. If the entire industry were required tomorrow to pay all of the casualty losses for which it is now liable, an alarmingly large number of companies would have sustained such large losses in investment portfolio values that they would be unable to do so.

What happened as investment yields escalated was that price competition on premiums grew much fiercer. Companies could write new business at lower premiums when they could invest the new premium dollar at 10 or 15% rather than at 5%. And they did. In the highly competitive marketplace the percentage of losses and expenses covered by the premium itself was driven downward. Combined ratios rose dramatically—from an industry average of 96.2% in 1972 to an estimated 118% in 1984. It is hard to imagine a more dramatic illustration of the competitive marketplace at work. Increases in investment yields were passed through swiftly to policyholders in the form of lesser premiums, even in the face of a weakened financial structure caused by declines in asset values created by the same inflation which created the higher yields.

This history is written plainly in the numbers. It illustrates a principle which is important for the Congress to understand in any review of the taxation of the insurance function. The principle is this: any increased costs imposed by generally applicable changes in taxes will, like any other general cost changes, be translated almost immediately into higher premium prices. If there are tax changes that impose costs retroactively, there may be a one-time loss to the entity administering the insurance, and ill-considered changes could cause that one-time loss to be large and devastating. But, prospectively, increased tax costs will be passed through by increasing premiums as swiftly and as surely as changes in investment yields have been passed through in reduced premiums in this inflationary period. Thus, changes in the nominal tax burden of insurance companies results in changes in the real financial burdens of individual policyholders.

Financial status of the P & C insurance industry

The recent economic climate has placed the P & C insurance industry in a serious financial posture. A recent report by A. M. Best Company, the leading analysts of insurance company financial and operating performance, indicates that of the 1,184 companies included in its review, 183—more than 15 percent—were assigned lower ratings in 1984 than in 1983. (Best's Insurance Management Reports, Property/Casualty, Release No. 18, Aug. 13, 1984).

And Mr. Joseph D. Sargent, managing partner of Conning & Co., a company that analyzes the financial status of the insurance industry primarily for insurers and investors, has stated that "as may as 100 insurers—about 5% of the 2,000 property/casualty insurers operating in the United States—can and should be shut down by state insurance regulations." He states further:

"We see an emergence of widening losses in the business brought about by inadequate rates.

"The industry is making no money and a lot of companies are losing enough money to be driven out of the business or to have large parts of their capital consumed by underwriting losses." (Business Insurance, p. 34, Oct. 29,. 1984)

He also projected industry earning of $33 million in 1984, compared with $2.7 billion in 1983. Even that gloomy projection proved overoptimistic. Even after the infusion of a record $3 billion of new capital (more than twice as much as any other year), the industry as a whole had a loss in net worth of almost $1.5 billion in 1984.

Taxes paid by the P & C industry

In recent years, the P & C industry has paid a lesser amount of tax than previously and a small amount ot tax relative to the volume of P & C business. Some have argued that this circumstance means that the industry is not paying its share and that something should be done to increase its tax liabilities.

The fact is that the industry's after-tax returns are depressed. P & C companies are clearly not profiting at the expense of the tax system. On the contrary, they have not been prospering at all.

There are two fundamental reasons why the P & C industry's tax liabilities have decreased. They are:

(1) Profits have been down. Premiums have been set too low; policyholders have not been charged enough to produce healthy profits. This condition is the result of the turmoil created by volatile economic conditions. There are some signs that situation may be improving, but it hasn't happened yet.

(2) The depressed level of profits that has been realized consists almost entirely of investment income. This, too, is a result of volatile economic conditions. A very large part of the investment income of P & C companies is—and, for years, has been—income from state and municipal obligations. That income is exempt. If there

is a problem in this, it lies in the fact the income on those obligations is exempt, not in the fact that the obligations are held by P & C companies.

A significant part of the insurance management function is the investment of premiums during the period between their receipt and their disbursement. For decades, a large part of those investments has been state and municipal bonds, the yield on which is tax-exempt. The proportion of exempt bonds in the total portfolio is higher for P & C companies than for many other taxable investors because the practicalities of insurance regulation require P & C companies to keep a major portion of their portfolios in bonds, as distinguished from other investments offering a higher but less certain yield potential. Although no firm figures are available as to the total amount of exempt securities outstanding or who holds them, it is generally believed that property and casualty insurance companies constitute the second largest non-individual market for state and municipal obligations.

The taxable income of P & C insurance companies consists basically of two components: "underwriting income" and "investment income". Underwriting income is the excess of premiums over losses and expenses. Investment income is self-explanatory. As a large segment of total investment income has traditionally consisted of exempt income from state and municipal bonds, only a fraction of the investment income component has been taxable. In earlier years, however, when premiums alone were more than sufficient to cover losses and expenses, there was a significant amount of underwriting income, all of which was taxable. As inflation has driven premiums down and investment yields up, underwriting income has been eliminated in most companies while investment income has grown. But, since underwriting income was taxable while investment income was in significant degree exempt, the total tax bill has dropped.

It is important to emphasize that a reduction in taxes remitted by a company does not make the company wealthier or more profitable when, as here, the reduction is passed through to policyholders in the form of lesser premium and there is, in addition, a massive loss in portfolio values.[12]

The drop in tax liabilities of insuring entities brought about in this way by inflation would, at first blush, suggest an accompanying drop in revenue to the Treasury. But there has in fact been no such drop in total revenues. On the contrary, the extensive holdings of exempt securities by P & C insurers has probably produced a net revenue gain to the U.S. Treasury as well as a cost savings to state and local treasuries.

What has happened is that the lesser tax payments of P & C insurers has been offset by greater tax payments by others, while the drop in tax payments of P & C insurers has been passed through to policyholders in the form of lower premiums. If P & C insurance companies had been forbidden to invest in state and municipal securities, their after-tax investment income would be less and the competitive marketplace would have caused premiums to be priced higher. The revenue loss to the Treasury from tax-exempt securities is a loss from the very existence of those securities, not from the manner in which they are held.[13] Whoever holds them, they will produce a stream of income which is exempt from tax, which will substitute for some other stream of income that would be taxable and which will, as a result, produce a revenue loss to the Treasury. The fact that they are held by P & C insurance companies rather than by wealthy individuals actually produces a revenue gain (or more correctly, a smaller revenue loss) because P & C insurance companies are taxed at a maximum marginal rate of 46% while top bracket individuals are taxed at 50%. Moreover, from an equity point of view, it is better to have them held by P & C companies as the benefits of the exemption that accrue to holders (as distinguished from those that accrue to state and local issuers) will flow through to ordinary policyholders in the form of lower premiums, which is obviously preferable to concentrating all those benefits on high bracket individuals.

In the case of any exempt security, a part of the investors' yield comes in the form of cash interest payments and a part comes in the form of tax benefits, i.e., exemption. As a result, the cash yield on state and municipal securities is less than the cash yield on comparable taxable securities. That results in lower borrowing costs for state and municipal governments. But the fact that a part of the real return consists of tax exemption (so that the cash component of the yield is less) means that state and municipal obligations are not purschased by taxpayers who cannot use the exemption benefit. Taxpayers who cannot use the exemption benefit because they are already exempt or because in their hands it is not available will simply buy fully taxable obligations which pay a higher taxable cash yield. Tax-exempt institutions, such as colleges and pension funds, for example, do not buy exempt securities because they must take a part of the return in the form of exemption and exemption is of no use to them.

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[12] In the case of many bond holdings, the rise in interest rates caused total investment return on the holding actually to be negative, i.e., the resulting drop in portfolio value was greater than the gross coupon income.

[13] Most of that revenue loss redounds to the benefit of states and municipalities in the form of lower borrowing costs, but a part of it is siphoned off to investors who are in high marginal tax brackets. For example, if a municipal bond yields 7% while a taxable bond yields 10%, the municipality has a 3% saving in borrowing costs, but a 50% taxpayer would also end up with a 2% greater after-tax yield, i.e., the difference between 7% and 5%, after tax.

So, too, if state and municipal bonds were taxable in the hands of P & C companies, P & C companies would simply not own them, as higher paying taxable bonds would be a better investment.

If the government had over the last ten years discouraged the holding of state and local securities by P & C companies in order to make P & C companies send in more dollars of tax, other taxpayers would have sent in less tax. The market for the sale of such securities would have contracted and state and local governments would have had to pay higher interest rates to sell their bonds. That would not only have increased the cost of state and local financing but would have increased the tax benefits for high bracket taxpayers holding the bonds. Meanwhile, the Treasury's revenue loss on the bonds actually outstanding would increase because a higher yielding stream of income would be exempt in the hands of other taxpayers. Only if the higher borrowing costs had caused state and municipal governments to issue fewer bonds or if the ownership patterns shifted so that the average marginal tax rate of holders was lowered would there have been any offset to that larger revenue loss.

Thus, as in many other cases, first blush impressions are misleading. When the entire process is analyzed and all of the moving parts are identified, it becomes apparent that, given the fact that we have tax exemption for state and local bonds, the drop in the taxes of P & C companies reflects an optimum (i.e., from the Treasury's point of view, the "least bad") operation of the exemption privilege utilized by state and local government issuers.

If Congress is genuinely concerned about reducing the revenue loss from state and local obligations, its only real option is to restrict the amount of such obligations that are issued, instead of permitting them to expand. Tax rules which only cause the ownership of such obligations to be shifted will, in reality, only make matters worse for everyone except high bracket taxpayers.

The proposals advanced by Treasury are fundamentally wrong.

They would tax a P & C company on more income than it economically has. That is unfairness, not fairness.

They would require complex new reserving procedures and necessitate much more difficult audit issues for policyholders. That is complication, not simplification.

They would impose heavy new financial liabilities on a financially depressed industry which will be an obstruction, not an aid to economic growth.

They would, in the name of leveling the playing field between stocks and mutuals, undo the leveling tht Congress did in 1962.

The funds held by the P & C insurance industry are primarily funds held for the account of others. The sound financial health of the industry is of major concern to the public, whose funds it holds. This is not the time to exact revenues which are not justified.

Exhibit A-1

Taxable Income vs. Actual Economic Income

Current Tax System

		Taxable Income			Actual Cash Income	
		1986	1987	2-years	2-years	
1.	Premium	$1,000.00	$ -0-	$1,000.00		
2.	Investment Income	120.00	129.65	249.65		
3.	Receipts	1,120.00	129.65	1,249.65	$1,249.65	Receipts
4.	Reserve Increase	1,000.00	-0-			
5.	Reserve Release	-0-	(1,000.00)			
6.	Loss Payout	-0-	1,000.00	1,000.00	1,000.00	Payments
7.	Amounts held or paid for others (exclusions from income § 832)	1,000.00	-0-	1,000.00		
8.	Taxable Income	120.00	129.65	249.65	249.65	Cash income before tax
9.	Tax	39.60	42.78	82.38	82.38	Tax
10.	Taxable Income, Minus Tax	$ 80.40	$ 86.87	$ 167.27	$ 167.27	Actual economic income, after tax
11.	Nominal Tax Rate			33%	33%	

Assumptions

- o 33% marginal tax rate
- o $1,000.00 premium received 1/1/86 is fully earned 12/31/86
- o $1,000.00 loss incurred on 12/31/86 is paid on 12/31/87
- o 12% taxable interest rate (8.04% after tax)
- o 9% tax exempt interest rate

Comment

- o Taxable income = actual economic income
- o Investment is income taxed when earned

Exhibit A-2

Taxable Income vs. Actual Economic Income

QRA Method: Original QRA Deduction Exactly "Correct" Under Treasury's Proposed Standard (i.e., Full Reserve Discounted by After Tax Rate of Investment Return)

		Taxable Income			Actual Cash Income	
		1986	1987	2-years	2-years	
1.	Premium	$1,000.00	$ -0-			
2.	Investment Income	120.00	126.70			
3.	Receipts	1,120.00	126.70	$1,246.70	$1,246.70	Receipts
4.	Reserve Increase	925.58	-0-			
5.	Reserve Release	-0-	(1,000.00)			
6.	Loss Payout	-0-	1,000.00	1,000.00	1,000.00	Payments
7.	Amounts held or paid for others (exclusions from income § 832)	925.58	-0-	925.58		
8.	Taxable Income	194.42	126.70	321.12	246.70	Cash income before tax
9.	Tax	64.16	41.81	105.97	105.97	Tax
10.	Taxable Income, Minus Tax	$ 130.26	$ 84.89	$ 215.15	$ 140.73	Actual economic income, after tax
11.	Tax Rate			33%	43%	

Assumptions

- o 33% marginal tax rate
- o $1,000.00 premium received 1/1/86 is fully earned 12/31/86
- o $1,000.00 loss incurred 12/31/86 is paid 12/31/87
- o 12% taxable interest rate (8.04% after tax)
- o 9% tax exempt interest rate

Treasury proposal-taxable income	$321.12	Full reserve	$1,000.00	Investment earnings, after-tax, on QRA reserve	$ 74.42
Actual cash income before tax	246.72	Discounted reserve	925.58		
Excess of taxable income over actual income	$ 74.42	Difference	$ 74.42		

Exhibit A-3

Taxable Income vs. Actual Income

QRA Method: Loss and Full Reserve Exceed Premium; Original QRA Deduction
Exactly "Correct" Under Treasury's Proposed Standard (i.e., Full Reserve
Discounted by After Tax Rate of Investment Return)

		Taxable Income			Actual Cash Income	
		1986	1987	2-years	2-years	
1.	Premium	$1,000.00	$ -0-			
2.	Investment Income	120.00	134.40			
3.	Receipts	1,120.00	134.40	$1,254.40	$1,254.40	Receipts
4.	Reserve Increase	1,203.26	-0-			
5.	Reserve Release	-0-	(1,300.00)			
6.	Loss Payout	-0-	1,300.00	1,300.00	1,300.00	Payments
7.	Amounts held or paid for others (exclusions from income § 832)	1,203.26	-0-	1,203.26		
8.	Taxable Income	(83.26)	134.40	51.14	(45.60)	Cash income before tax
9.	Tax	-0-	16.88 *	16.88	16.88	Tax
10.	Taxable Income, Minus Tax	$ (83.26)	$ 117.52	$ 34.26	$ (62.48)	Actual economic income, after tax
11.	Tax Rate			33%	infinity	

* After giving effect to $83.26 NOL from 1986.

Assumptions

- 33% marginal tax rate
- $1,000.00 premium received 1/1/86 is fully earned 12/31/86
- $1,300.00 loss incurred 12/31/86 is paid 12/31/87
- 12% taxable interest rate (8.04% after tax)
- 9% tax exempt interest rate

Treasury proposal-taxable income	$ 51.14	Full reserve	$1,300.00	Investment earnings, after-tax, on QRA reserve	$ 96.74
Actual cash income (loss) before tax	(45.60)	Discounted reserve	1,203.26		
Excess of taxable income over actual income	$ 96.74	Difference	$ 96.74		

Exhibit A-4

Taxable Income vs. Actual Economic Income

QRA Method: Original QRA Deduction is Equal to Full Reserve
(and is, Therefore, "Excessive" and Subject to Recapture)

		Taxable Income			Actual Cash Income	
		1986	1987	2-years	2-years	
1.	Premium	$1,000.00	$ -0-			
2.	Investment Income	120.00	129.65			
3.	Receipts	1,120.00	129.65	$1,249.65	$1,249.65	Receipts
4.	Reserve Increase	1,000.00	-0-			
5.	Reserve Release	-0-	(1,080.40)			
6.	Loss Payout	-0-	1,000.00	1,000.00	1,000.00	Payments
7.	Amounts held or paid for others (exclusions from income § 832)	1,000.00	(80.40)	919.60		
8.	Taxable Income	120.00	210.05	330.05	249.65	Cash income before tax
9.	Tax	39.60	69.32	108.92	108.92	Tax
10.	Taxable Income, Minus Tax	$ 80.40	$ 140.73	221.13	140.73	Actual economic income, after tax
11.	Tax Rate			33%	44%	

Assumptions

- o 33% marginal tax rate
- o $1,000.00 premium received on 1/1/86 is fully earned on 12/31/86
- o $1,000.00 loss incurred on 12/31/86 is paid on 12/31/87
- o 12% taxable interest rate (8.04% after tax)
- o 9% tax exempt interest rate

Treasury proposal-taxable income	$ 330.05
Actual cash income before tax	249.65
Excess of taxable income over actual income	$ 80.40

Investment earnings, after tax, on QRA reserve $ 80.40

Amount of of recapture $80.40

Exhibit B

RESOLUTION OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Whereas, the Members of the National Association of Insurance Commissioners (NAIC) are responsible for supervising and maintaining the financial solvency of companies engaged in the business of insurance in the United States; and

Whereas, The United States Treasury has proposed changes to the Internal Revenue Code which would alter the way insurers are taxed, and

Whereas, after more than two years of study the Treasury and Congress agreed to the 1984 Life Insurance Company Tax Act provisions which affirmed the role of state regulatory authorities in safeguarding insurance company solvency by prescribing life insurance company tax reserves to be not less than those prescribed by the minimum standards of a majority of the states; and

Whereas, the proposal to limit life insurance company reserves to amounts solely equalling cash values is a disincentive for maintaining adequate reserves for future obligations under life insurance contracts; and

Whereas, proposals to tax insurers selling property and casualty, health insurance, and other non-life insurance products include a qualified reserve account method which fails to recognize minimum statutory reserves required by and established for those products; and

Whereas, the proposed changes in the Internal Revenue Code would act as strong disincentives for insurers to adequately reserve for losses

Now be it therefore resolved that: 1. The National Association of Insurance Commissioners opposes any method of taxing insurers, such as the qualified reserve account method, which would weaken the tax laws' recognition of state statutory accounting rules and their traditional methods of reserving for policyholder benefits, claims and losses, and

2. To the extent any change in the system of taxing insurers is deemed necessary, the NAIC strongly urges Congress to pursue alternative methods of taxation which are consistent with the President's proposal for tax reform—simplicity and fairness, which contain incentives for adequate and sound loss reserving, and which operate in harmony with state statutory accounting rules designed to preserve the safety and soundness of insurers.

STATEMENT OF FRANKLIN W. NUTTER, PRESIDENT, ALLIANCE OF AMERICAN INSURERS, CHICAGO, IL

The CHAIRMAN. Mr. Nutter.

Mr. NUTTER. Mr. Chairman, members of the committee, I am Franklin Nutter, president of the Alliance of American Insurers. Pursuant to the panel's agreement, I'm going to address only one provision of the President's tax reform package—the reduction in the deduction allowed for mutual insurance companies for dividends paid to policyholders.

The proposal is similar to that contained in the Deficit Reduction Act of 1984 applicable to mutual life insurance companies. I should say at the outset that neither stock insurers nor mutual insurers agree with the President's proposals.

Policyholder dividends are a return of premium, the premium which is unnecessary to pay losses in loss-sensitive lines. Under current law, insurance companies, both stock and mutual, are permitted a deduction for policyholder dividends. They bear no relationship to stockholder dividends. And, in fact, both stock and mutual insurance companies pay policyholder dividends, as much as $1.1 billion each in 1983.

In the Deficit Reduction Act of 1984, the Congress adopted a provision regarding the ownership differential for mutual life insurance companies. The administration seeks to expand this proposal and extend it to property/casualty insurance. That raises as yet unanswered questions.

Is there a purported competitive imbalance between stock and mutual property/casualty companies? Is there an after-tax return on equity materially different between mutual and stock insurance companies?

While no segment of the property/casualty industry suggests that either is true, the administration makes this barefaced allegation, suggests tax reform and calls for a study to determine the validity of its own assumptions.

The Deficit Reduction Act of 1984 dealt with the ownership differential for mutual life insurance companies pursuant to an agreement within the industry. The driving force behind the change was a concept entitled "Segment Balance," which reflected the strong position of mutual life insurance companies in that industry.

There is no place for this concept in the property/casualty insurance industry where stock insurers write the majority of the business. Obviously, the Treasury could not, therefore, allege a competitive imbalance between stock and mutual property/casualty companies and propose, then, an additional tax on mutual companies only.

The major difference between property/casualty and life insurance is one which the administration ignores. Many life insurance products have an essential investment element. That is not so with property/casualty insurance. Property/casualty policyholders buy protection; not investments. And most of the policyholder dividends which would be subject to this additional tax are paid in one line of insurance—workers compensation.

The dividend is a return of premium and not a return on equity for the policyholder base as a whole. If calculated, as was the case in the 1984 act, applicable to life insurance companies. The Administration's proposal is essentially a new tax on mutual insurance companies only.

Neither the Treasury, the administration, nor the insurance industry assert a meaningful difference on return on equity for mutuals versus stocks. There is no assertion that stocks pay a disproportionate amount of the tax liability. And there is no alleged competitive imbalance to be rectified.

We urge the committee not to accept the President's tax reform proposal applicable to a limitation on the deduction for policyholder dividends.

Thank you.

The CHAIRMAN. Thank you, sir.

[The prepared written statement of Mr. Nutter follows:]

TESTIMONY
OF THE
ALLIANCE OF AMERICAN INSURERS

I. Introduction

My name is Franklin W. Nutter. I am president of the Alliance of American Insurers, a national trade association of over 175 property/casualty insurance companies. We appreciate the opportunity to testify before you about the potentially catastrophic effects that the Administration's property/casualty tax proposals, if enacted, would have on this industry, American business and the public that depends upon it for financial protection. Before we discuss the Administration's proposal and the General Accounting Office's ("GAO") suggestions, we want to review the overall effect of those proposals and the reasons for the current property/casualty tax system.

Effects of Administration and GAO Proposals

Advanced in the disguise of "tax reform", the Administration's property/casualty tax proposals will damage this industry and the American economy in the following ways:

- Policyholders will pay significantly more for insurance.
- Coverage in several lines of insurance business will become less available, perhaps even unavailable.
- Regulators will be less able to assure that insurance companies remain able to pay their policyholders and claimants.

- The long-standing public policy promoting insurance over non-insurance will be reversed, leaving policyholders and claimants no place to go if those who wrong them are unable to pay.

These effects are not the result of a tax plan that promotes "fairness, growth and simplicity". Indeed, the Administration's property/casualty proposals are unfair, anti-growth and far more complex than the present system -- one that has well served the industry, its policyholders and the public for more than 60 years.

Public policy issues raised but unanswered

The Administration's property/casualty tax proposal also creates several fundamental public policy conflicts which the Treasury did not purport to address but which the Congress must resolve. In seeking a change in the long-standing tax system, the Administration bears the burden of demonstrating the need for change in light of the following problems that it creates:

- The proposal encourages non-insurance over the security and the stability of insurance through licensed and regulated companies under current policy.
- It is in conflict with the fundamental tax policy precept that an income tax should tax only taxpayers with true economic gain.
- It is driven principally by the desire for tax revenue while in direct conflict with current policy favoring regulatory and solvency goals.

- The proposal would inhibit capital growth and new capital formation -- an internal conflict within the proposal itself.
- The proposal makes the Internal Revenue Code more complex and compliance more costly and complicated, in contrast to its purported goals of simplification.

The Congress should not presume that the Administration gave careful consideration to these conflicting public policy goals.

The one business that all business needs

The property/casualty insurance industry is, truly, the one business that all other business needs. It accepts and spreads the risk of losses of all kinds -- automobile, fire, property damage, legal liability, injuries to workers, many others -- and makes it possible for both large and small business to deal with these risks in a practical, economical way. It gives them certainty and enables them to plan for the future, thereby promoting economic growth. If companies are unable to obtain insurance, or if insurance is too expensive, they may have to severely alter their methods of doing business. In some cases, they may even be forced to close. These lamentable effects are being seen even now in some lines of insurance where the unpredictable expansion of legal liability has made some businesses -- asbestos removers, many doctors and lawyers, some daycare centers, some corporate directors and officers -- virtually uninsurable. Now the Administration's tax proposal threatens to further restrict the property/casualty industry's financial strength at a time when, as we will show, the industry is recovering from its worst fiscal performance in history. Further hobbling the industry that supplies certainty and risk protection for all American business is no way to promote the economic growth we all need.

Current property/casualty tax and regulatory system

Our industry is taxed in virtually the same manner as is every other American industry. Property/casualty companies, like almost all other corporations, pay taxes upon their total income (with the exception of income from tax-exempt securities and 85% of stock dividends, investments that are available to all corporations). The only significant difference in tax treatment is that the Internal Revenue Code recognizes the accounting system ("statutory accounting") required by the National Association of Insurance Commissioners ("NAIC"), the nationwide association of the state insurance regulators, for tax accounting purposes. The primary goal of this system, as of insurance regulation in general, is to protect the public by making sure that insurers are able to pay their claims. Statutory accounting recognizes that property/casualty insurers, unlike other corporations, incur their costs after they are paid for their services, and thus cannot know their income until long after they are paid. Since most of an insurer's liabilities are for claim payments and related expenses, most of which are paid in later years, reserves reflecting those liabilities must be established when claims are reported to the company.[1] These reserves, for an insurer's ultimate liabilities, must be deducted from its gross receipts in order to arrive at its true net income.

State insurance regulators require that these reserves be established at their full values so that regulators, investors and policyholders can accurately determine an insurer's true financial condition. Statutory accounting protects policyholders and claimants by ensuring that, as of December 31 of each year, a property/casualty company has enough assets to pay all claims against it if it were to go out of business immediately. Reserving for losses at their full values is essential to this process, because inadequate reserving understates a company's loss costs and makes its "policyholders' surplus", or net worth, and its earnings appear higher than they really are. Companies also base their pricing decisions on loss reserves, and inadequate reserves contribute to inadequate prices, the industry's major financial problem today. Since loss reserves are a company's largest liabilities, the inaccuracy that underreserving brings makes it much more difficult for regulators and even company managements to assure that company financial statements are in fact accurate and that companies will have the funds necessary to respond to the claims they must pay. Our later discussion of the specific Treasury and GAO proposals dealing with loss reserve discounting will illustrate the added inaccuracies they bring to the reserving process.

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[1] Insurers also establish reserves for claims that, at the end of a calendar year, have not been reported but that experience shows have been incurred during that calendar year and will be reported later. These claims are called "incurred but not reported", and a company must be able to reserve for them because the claims exist, are funded by that calendar year's premiums and will have to be paid.

Congress recognized in 1921, and has continued to recognize since, that statutory accounting is the proper accounting system for tax purposes as well. If insurers are not allowed to deduct losses when they are reported, they will be taxed on income that does not yet exist, because that income must be used to pay reported claims. Congress has also recognized the wisdom in an accounting system that helps to guarantee insurer solvency and, through it, the financial safety of personal and business policyholders and claimants. Therefore, Internal Revenue Code Section 832 incorporates statutory accounting principles into the Code for property/casualty companies, perpetuating a system that has taxed insurers on their true income, as other corporations are taxed, and protected policyholders and claimants for the past 60 years.[2]

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[2] The Treasury and the GAO argue that the property/casualty industry is undertaxed. To the extent this may appear to be true, it is largely because the industry is a major institutional investor in tax-exempt state and municipal

Current industry financial condition

Property/casualty insurers are in the throes of the worst financial slump in the history of a very cyclical industry. In 1984, the industry suffered a pre-tax operating loss of nearly \$3.7 billion.[3] Policyholders' surplus, in effect the industry's net worth, declined by over \$1.6 billion.[4] The results of 1984, the worst single year in the industry's history, follow five years in which the industry has suffered consistently increasing losses from the basic business of insurance -- collecting premiums to pay for losses and expenses. This period has featured extreme price competition

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Footnote continued

bonds. As of 1983, property/casualty companies held approximately 19% of all outstanding tax-exempt securities, according to Salomon Brothers, Inc.'s *1983 Prospects For Financial Markets*, p. 26. In holding and buying tax-exempts, property/casualty companies of course accept a lower pre-tax rate of return than they would receive if fully invested in taxable obligations. In doing so they are giving effect to the congressional judgment that public policy justifies the lowering of borrowing costs for state and local governments through the tax code. In doing so they are also paying an implicit tax to the states and local governments whose bonds they hold--just as real as the taxes paid directly to the Treasury--in the amount by which their yield on tax-exempts is lower than their pre-tax yield on taxables. This amount averaged \$2.5 billion per year during 1979-1983, as shown in Appendix I. This implicit tax goes directly to states and municipalities in the form of lower borrowing costs.

[3] *Best's Advance Rating Reports*, A.M. Best Company, Oldwick, New Jersey, July 15, 1985, p. 1.

[4] *Best's Advance Rating Reports*, p. 1.

among insurers, as many underpriced their business in the search for cash that could be used to earn investment income at the high interest rates of the late '70s and early '80s. The increasing and unpredictable new liabilities created by the tort system have also accelerated the increase in losses, while interest rates have decreased and the rise in investment income has not kept pace with the companies' increasingly bad underwriting results. In 1984, the industry's combined ratio (losses plus expenses/premiums) was approximately 118 -- $1.18 incurred for losses and expenses for every $1 received in premiums. The $21.3 billion underwriting loss this produced overwhelmed the approximately $17.7 billion in investment income the industry received.[5] These massive losses drove 20 companies into insolvency last year and left many insurers, including some large ones, in severely weakened financial condition. Although many companies are now beginning to charge higher premiums that are more in line with loss costs, particularly for commercial business, the results for 1985 have so far been little better than for 1984. The industry may not return to profitability until 1986. Since the amount of business companies may safely write is expressed as a ratio of premiums/policyholders' surplus, 1984's $1.6 billion surplus loss has reduced the industry's ability to write new business. 1985 results are unlikely to increase that capacity, at a time when the Insurance Services Office estimates that the demand for insurance will exceed by $62 billion the amount that insurers will be able to write during the years 1985-1987.[6] It is at this time that the Treasury proposes to deplete the industry's financial capabilities with its series of ill-advised proposals.

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[5] Best's Advance Rating Reports, p. 1

With this as the background, we will now turn to a discussion of the specific Administration and GAO proposals.

II. "Qualified Reserve Account" loss reserve discounting

The centerpiece of the Administration's property/casualty tax proposals is the "Qualified Reserve Account" ("QRA") loss reserve discounting concept. Indeed, it should be, for the harm that QRA would do to the property/casualty industry and the U.S. economy dwarfs the effects of the Administration's other insurance proposals[7]:

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[6] The Coming Capacity Shortage, Insurance Services Office, Inc., February, 1985, p. 5.

[7] Although it is not explicitly stated in either Treasury I or the Administration's proposal, we assume that QRA would also apply to loss adjustment expense reserves, which are reserves for future expenses incurred in the adjustment of losses that have already occurred.

1. QRA is a technically-flawed concept that ignores the real-world complications of loss reserving.

Anyone would agree that an income tax that imposes tax liability when a taxpayer has no income is an absurd and unjust tax. The QRA proposal, however, does exactly this, while it ignores the many reasons why property/casualty loss reserves should not be discounted. A closer look will show why.

a. Discounting of loss reserves is unwise.

"Discounting" loss reserves is a mechanism for recognizing the time value of money with respect to loss reserve deductions. The idea is that, since many claims are paid in a later taxable year than the year in which they are incurred, the reserve deduction in the first taxable year should be reduced to the amount which, when combined with the investment income earned on the reserve until the claim is paid, will be enough to pay the claim. This is the basis of the GAO's discounting proposal, which (unlike QRA) discounts loss reserves by the pre-tax rate of investment return on those reserves and then (also unlike QRA) shelters the investment income earned in the following years so the reserve can build up to an amount sufficient to pay the underlying claim. It is also part of the theoretical underpinning of QRA.

There are two major problems with applying this theoretical construct to the real world of property/casualty insurance operations. First, discounting makes reserves unacceptably inaccurate because it adds two additional variables, that cannot be estimated accurately, to the reserving process. Loss reserving is a process of sophisticated estimation, in which many factors, such as magnitude of injury, inflation, changes in the law, likelihood of litigation and other factors must be projected years into the future in order to arrive at the estimated ultimate amount of the claim. Even with the great reserving experience and expertise that insurers currently possess, the Insurance Services Office estimated that property/casualty reserves at the end of 1982 were over 10% inadequate.[8] Discounting adds two new variables:

1) the correct discount rate, which is the future rate of investment return on discounted reserves, and

2) the correct claim payment rate, the future rate at which discounted claims will be paid.

These factors simply cannot be known at the time discounted reserves are established. And discounting, which by its nature involves reducing the amount of a loss reserve, is likely to cause even greater underreserving. Given the critical need of insurers, regulators and the public for accurate and adequate loss reserves (see pp. 5-6 above), a system such as discounting that guarantees greater inaccuracy is bad public policy.

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[8] Remarks of Daniel J. McNamara at the Thirteenth Annual Meeting of the Insurance Services Office, Inc., January 10, 1984.

Second, discounting results in the taxation of anticipated income. By discounting a loss reserve, the investment income on that reserve is taxed before the company ever receives it. If a company incurs a $100 loss at the end of taxable year 1 that is discounted to $90 because it will not be paid until the end of taxable year 2, the company is taxed upon $10 of investment income in taxable year 1 that it will not receive until taxable year 2. This is an unjust result, and one that should not be enshrined in the Code.

b. QRA goes even further than discounting -- it taxes nonexistent income.

Treasury representatives have stated adamantly that QRA is not discounting, because there is no requirement that a company's initial reserve be discounted. In a sense, they are right -- the economic result of QRA is the equivalent of denying insurers the right to deduct loss reserves at all. In effect, QRA puts property/casualty insurers on the cash basis of discounting.[9] That is the intent of its drafters.

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[9] It is interesting to note that Chapter 8.03 of the President's proposal would require most large corporations to reject the cash of accounting for the accrual basis, in order to more accurately measure income. Property/casualty statutory accounting is in most respects similar to the accrual basis. See The President's Tax Proposal to the Congress, pp. 212-214.

If a company is fortunate enough to establish a perfectly-discounted reserve under QRA -- estimating the correct (after-tax) discount rate and the correct claim payout rate, as well as getting the amount of the claim exactly right -- its discounted deduction will be the only one it will ever get, because *additions to the reserve are not deductible*. Thus *an insurer that sets up a correctly-discounted initial reserve to pay a $100 claim will never get a full $100 in deductions*. And since QRA is designed to produce economically equivalent results no matter whether a reserve is established and no matter what the amount of the initial reserve is, the economic effect will be that *no insurer will ever get a full deduction for its loss reserves*. This unfair result is not even theoretically correct, for QRA produces situations in which *insurers with no or negative economic income pay tax*. A recent paper by the American Academy of Actuaries illustrates this point (Appendix III, p. 2):

> "Consider a single policy written under the following circumstances:
>
> - A $100.00 loss will be paid after two years.
> - There are no expenses.
> - The taxable interest rate is 10%.

> Suppose the company prices the policy so that it exactly breaks even. It charges a premium of: \$100.00 divided by $(1.10)^2 = \$82.64$
>
> Under this policy, the company achieves *no economic gain*. The full investment income at 10% *is required*, along with the premium, to discharge the \$100.00 obligation. Under such circumstances, it is reasonable to argue that no *income* tax should be paid. However, the Administration's proposal would impose a tax in this situation."[10] (emphasis added)

It should also be noted that the company in this example would not be allowed by QRA to raise enough investment income to pay the claim. Certainly, an income tax proposal that taxes companies when they have no economic income and denies them the ability to raise enough revenue to pay their claims is theoretically unfair as well as unconscionable in the real world.

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[10] QRA would impose a tax of \$4.05 in this situation, as shown below:

	Current law	QRA
Income		
Premium	\$ 82.64	\$ 82.64
Investment income	17.36	17.36
Gross income	100.00	100.00
Deductions		
Actual losses	100.00	100.00
Deductible losses	100.00	87.84
Real economic income	0	0
Taxable income	0	12.16
Tax (33%)	0	4.05
After-tax income	0	(4.05)

The initial QRA reserve (deductible losses in the QRA column) is \$100 divided by $(1.067)^2 = \$87.84$, which is the loss discounted by the 6.7% after-tax rate of return over two years.

c. Property/casualty and life reserves are very different.

Treasury again demonstrates its lack of knowledge of our industry when it analogizes from the discounting of life insurance reserves to argue that property/casualty reserves should be discounted. Although both bear the name "insurance", they are very different businesses. Reserves on whole life policies are set when a policy is sold, before any claim arises. Actuarial mortality and morbidity tables give a very high degree of predictability to life insurance losses, and investment income is explicitly relied upon to build reserves. Property/casualty companies, in contrast, do not establish reserves until a claim is reported to them (except for "incurred but not reported" reserves, see p. 5, footnote 1), the correct amounts of reserves and claim payment rates are far less predictable and reserves are not built up with investment income. QRA shows the extent to which Treasury has confused the two businesses, and the GAO's analysis is subject to the same misconceptions.

2. *QRA will greatly increase the cost of insurance*. QRA would impose a massive and unsupportable tax increase upon the property/casualty industry. Indeed, this may be a rare area where the Treasury's revenue estimators undershot their mark. While Treasury I estimates[11] that QRA would raise some $14.7 billion over five years, ranging from $1.8 billion in 1986 to $3.4 billion in 1990, the Administration's estimate[12] is that its slightly-revised proposal would raise only $5.6 billion over five years. The Joint Committee on Taxation's estimate was $5.5 billion.[13] It should be noted, however, that the predicted revenue rises steeply from $100 million in 1986 to $2.4 billion in 1990 ($0 to $2.3 billion in the Joint Committee's estimates). It is extremely interesting that all of the estimates of the revenue raised in the fifth year are closed, and the trend of all of them is straight up. A study by Robert A. Bailey, vice president of

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[11] *Tax Reform for Fairness, Simplicity and Economic Growth*, Vol. 1, U.S. Department of the Treasury, November, 1984, p. 250.

[12] *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity*, May 29, 1985, p. 457.

[13] *Estimates of President's Tax Reform Proposal*, Joint Committee on Taxation, July 25, 1985.

the Property/Casualty Division of the A.M. Best Company (attached as Appendix II) concluded that QRA would have produced $4.8 billion in increased tax liability in 1983, even with a 33% corporate rate. The industry's net pre-tax operating income for that year was, interestingly enough, $2.7 billion.[14] Most of the internal studies in the property/casualty industry are predicting tax increases caused by QRA of $3-5 billion per year. Tax increases of this magnitude would likely, over a two-to-three year period, overwhelm the large net operating loss carryforwards that the industry currently has due to its poor recent financial results. Despite these very real losses, QRA will make its bite felt very quickly.

It is clear that tax revenue increases of this size will require companies to increase premiums signficantly just to compensate for the effects of QRA. The Bailey study (using the current 46% tax rate) estimates the following rate increases, produced solely by QRA:

All lines	11%
Medical malpractice	32%
General liability	24%
Workers compensation	15%

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[14] 1985/A Critical Year, Insurance Services Office, Inc., and National Association of Independent Insurers, May, 1985, p. 14.

Joseph W. Levin, vice president and actuary at Employers Reinsurance Corp., has made the following similar estimates (Appendix III, p. 3):

	33% tax rate	46% tax rate
Auto liability	7.5%	15.1%
General liability	15.2%	32.6%
Medical malpractice	17.1%	31.8%
Workers compensation	10.6%	20.5%
All lines	8.0%	17.2%

These increases would be added to the large increases insurers are implementing in these lines just to begin to underwrite insurance again on an economically sound basis -- increases of 50-100% in many cases.[15] It can also be seen that the QRA-produced increases are greatest in the business lines of insurance. Many of these extra costs will surely be passed through to consumers in price increases of goods and services as a "hidden tax". And they will make it much more difficult for American business to do business.

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[15] Industry premium writings increased by 17.42% in the first six months of 1985, including increases of 58% for other liability, 42% for medical malpractice, and 31% for commercial multiple peril. Best's Insurance Management Reports, Property/Casualty, Release No. 19, A.M. Best Company, Oldwick, N.J., September 2, 1985.

3. QRA will reduce the availability of insurance. The tax increases imposed by QRA will come directly out of the industry's capital and surplus. Regulators (and company managements) use a company's ratio of premiums/surplus to judge how much business a company can safely write. When a company's premium/surplus ratio becomes as high as 3:1, regulators generally become concerned -- indeed, that is one of the 11 tests in the NAIC's "early warning" financial testing system, designed to help regulators determine as early as possible when a company may be getting into financial trouble. With 1984's $1.6 billion surplus decrease, the industry's premium/surplus ratio increased from approximately 1.7:1 to approximately 1.9:1. Since many companies are implementing large premium increases in an attempt to return to realistic underwriting, the industry's premium/surplus ratio may continue to increase in 1985. Many individual companies are already near or over the 3:1 mark now, and more are likely to be close at the end of 1985. QRA's removal of $3-5 billion per year from industry surplus will push premium/surplus ratios even higher, and deprive the industry of the capacity it needs to satisfy the public's need for property/casualty coverage.

   This decrease in the industry's capacity to write insurance would come at a time when societal changes, particularly the explosion of litigation, are making insurers much less able to insure certain risks. The unpredictable expansion of theories of legal liability, the judicial tendency to expand policy language to provide coverage in situations where coverage was never intended, and recent dramatic increases in the cost of providing legal defenses to policyholders have imposed costs upon insurers for which they were never able to collect premiums. The response of many companies has been to stop or reduce their writings in the lines most affected by these developments. The result is that many doctors are now unable to obtain adequate medical malpractice coverage, many lawyers are finding legal malpractice insurance unaffordable or unavailable, and many asbestos removers, day care center operators and businesses that need general liability and directors and officers coverage are experiencing difficulty in securing coverage. The lines that are most affected by these societal and legal developments -- medical malpractice, general liability, other business coverages -- are the lines that QRA will affect the most because of the relatively long time that it takes for these claims to develop and be paid. QRA will simply make some difficult coverages unavailable, and deny insurance protection to many American businesses and professionals.

4. QRA encourages non-insurance of risks. One of the explicit principles behind QRA is that tax law ought not to favor insurance of risks over non-insurance. This novel precept apparently holds that there is no societal value in encouraging individuals and businesses to pool their risks so that they can receive certainty in place of uncertainty and make sure that the general public will be compensated for the losses caused by those who pool their risks. In fact, the economic effect of QRA is, and is designed to be, to deny insurers the ability to deduct reserves for the losses they must pay. QRA is designed to put property/casualty insurers, in effect, on the cash basis of accounting for losses, just as are those who do not insure (sometimes incorrectly called self-insurers).[16] This does not "level the playing field" between insurers and non-insurers; it puts insurers at a significant disadvantage. Property/casualty insurers are very closely regulated by the states -- non-insurers are not. Insurers must meet stringent capital and surplus

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[16] So-called "self-insurers" are not that at all. It is impossible to "self-insure", because insurance requires the transfer and spreading of risk from a single person or entity to several unrelated persons or entities. See Helvering v. LeGierse, 312 U.S. 532 (1941). "Self-insurers" are really non-insurers -- persons who have chosen to bear their own losses and to bet that they will be able to make them good.

requirements to write business in any state -- non-insurers generally do not. Insurers are required by state law to establish loss reserves -- non-insurers are not. Finally, property/casualty companies must participate in guaranty funds that pay policyholders and claimants of insolvent insurance companies. Non-insurers are under no obligation to satisfy claimants of fellow non-insurers that become bankrupt -- claimants that may be paid, if at all, under the bankruptcy laws, at the rate of a few cents on the dollar.

It is unsound social policy to discourage a private system that promotes economic security and stability and ensures that innocent claimants are paid for their injuries and to encourage a system that leaves those claimants to the tender mercies, delays and percentages of the bankruptcy courts. If these costs are not met by private industry, the Government will come under great pressure to meet them. It is also unwise to promote non-insurance while the great bulk of American business, especially small business, does not have the size or expertise to manage its own risks. Yet that is exactly what the Treasury is proposing.

5. QRA will disadvantage American insurers in foreign competition. Property/casualty insurance is an international business. The price increases and

administrative expenses QRA will generate, both in direct insurance and reinsurance, will *hurt* American companies *both* in *competition for U.S. and foreign risks*. Many foreign companies write excess and surplus insurance on U.S. risks without having a sufficient presence in the U.S. to subject them to American tax law. Much reinsurance is also ceded to foreign reinsurers by U.S. direct insurers. Those foreign reinsurers are again not subject to U.S. income taxes.[17] Thus, many foreign insurers will not be affected by QRA, while American companies will be. The effect will be particularly severe in the case of reinsurance, which is peculiarly international in nature. Recent testimony of the Reinsurance Association of America [18] indicates that *QRA would cause a net $9.8 billion outflow* from the American reinsurers into the foreign market. With the entire

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[17] Insurance of U.S. risks by foreign insurers and reinsurance ceded by U.S. insurers to foreign reinsurers is subject to a U.S. excise tax, 4% for direct insurance and 1% for reinsurance. I.R.C. Section 4371. But many tax treaties, including the one with Great Britain, where the largest proportion of U.S. risks are reinsured, exempt the foreign country's insurers and reinsurers from the tax.

[18] *Statement of the Reinsurance Association of America before the House Ways and Means Committee, July 19, 1985, Property & Casualty Taxation*, p. 25 and Appendix B, p. B-41.

American economy under extreme pressure from foreign competition, with the U.S. becoming a debtor nation overall for the first time, this is hardly the time to enact a proposal that will further harm American business. Here, too, American jobs are at stake.

6. QRA threatens the basis of insurer solvency and state regulation. Since the enactment of the McCarran-Ferguson Act in 1945, Congress has rightly recognized that the business of insurance should be regulated primarily by the states. The fundamental principle of state regulation has always been to protect policyholders and claimants by ensuring that insurers remain able to meet their ultimate obligations. The cornerstone of this policy has been statutory accounting, with its conservative emphasis upon ensuring that a company can at all times pay all outstanding claims from it s assets if it stops writing business. The most important statutory accounting practice, as mentioned earlier, is reserving for losses at their full values.

Although Treasury claims that QRA will have no effect on statutory accounting, it again ignores common sense. QRA will uncouple statutory accounting from the Internal Revenue Code. It will require insurers to maintain two different sets of reserves -- one for tax purposes and one for regulatory and corporate use. Under QRA, statutory accounting may be forced to include a deferred tax account to account for the future tax liabilities of companies that choose to establish full initial reserves under QRA to maximize cash flow, and pay more taxes later when claims are paid.[19] The amount in the deferred tax account will be very difficult to predict, since companies cannot know their future after-tax rates of return on investment or their future claim payout rates. This uncertainty will degrade the accuracy of all insurer financial statements and reduce regulators' abilities to ensure company solvency. If QRA loss reserves were ever to be adopted for statutory accounting purposes as well, accuracy, and the concomitant effectiveness of state regulation (or any kind of regulation), will be greatly reduced. The National Association of Insurance Commissioners has noted the dangers posed by QRA and has recently adopted a resolution opposing

> "any method of taxing insurers, such as the qualified reserve account method, which would weaken the tax laws' recognition of state statutory accounting rules and their traditional methods of reserving for policyholder benefits, claims and losses."[20]

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[19] This occurs because deferring taxes under QRA by taking an initial deduction larger than an accurately-discounted reserve causes the deferred taxes to be paid with interest when the claim is paid.

[20] Resolution of the National Association of Insurance Commissioners, June 14, 1985. This position was reemphasized in the testimony of Bruce Foudree, Iowa Commissioner of Insurance, representing the NAIC before the House Ways and Means Committee on July 19, 1985.

Finally, the massive tax increase imposed by QRA is one that the industry simply cannot bear at this time. A number of companies, small and large, are in very poor financial condition due to the industry's current results. The tax impact of QRA, which can impose an "income" tax when companies are actually losing money, could force some of these companies into insolvency and consign others to a much longer and greatly troubled convalescence. For over 60 years, the Internal Revenue Code and the Congress have shared with the states their concern for protecting the general public by assuring the safety and soundness of insurers. Now, after a year in which the industry lost $3.7 billion, the Treasury argues that safety and soundness are of no concern to the tax code.

7. QRA will be very complex to administer. The General Accounting Office opposes the QRA concept, and a primary reason is its inherent complexity.[21] QRA requires establishment of individual QRA accounts for each line of business for each policy year. Insurers keep records on an accident year basis (which groups claims according to the year in which claims are incurred), rather than a policy year basis (which groups claims according to the year in which the underlying policies were written). The

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[21] Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry, Report to the Chairman, Committee on Finance, United States Senate, by the Comptroller General of the United States, March 25, 1985, pp. 28-29.

transition will be very expensive, especially for small companies with limited resources. The American Academy of Actuaries report excerpted in Appendix III also estimates that companies would eventually be required to keep over 100 individual QRA accounts.[22] Again, this level of complexity will be much more difficult for small companies, many of which do not employ actuaries. QRA is certainly not "tax simplification", nor do we believe it is reform.

8. QRA will be detrimental to small business. Small businesses must be able to obtain insurance. They do not have the size, the diversification of risks or the expertise to go without insurance, as some larger corporations feel they can. QRA affects most the business coverages they need, raising their cost and reducing their availability. It will also have a devastating effect on small insurers, which provide the bulk of coverage for small businesses and agriculture in America's rural areas.

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[22] Analysis of Qualified Reserve Account Tax Proposal, American Academy of Actuaries, Committee on Property and Liability Insurance Financial Reporting Principles, July, 1985, p.II.C.2.

9. Drafting legislation, technical corrections and regulations will be extremely difficult. The President's QRA proposal would require a great deal of clarification if a company would ever try to put it into practice. It is not clear, for example, how significant liabilities such as loss adjustment expense reserves and the unearned premium reserve would be affected. Much would depend on technical corrections and regulations, and the industry is still waiting for some regulations from TEFRA in 1983. If a general tax reform proposal is enacted, Treasury and IRS staff will of course be swamped with regulations projects. The industry cannot live with the kind of uncertainty any delay in clarification here would produce, and delay would be inevitable.

III. General Accounting Office loss reserve discounting

The GAO has advanced its own proposal for loss reserve discounting.[23] The prime differences between GAO discounting and QRA are the following:

1. Insurers under GAO discounting would use their pre-tax rate of investment return, rather than their after-tax rate, to discount their initial reserves.

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[23] Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry, pp. 9-22.

2. GAO discounting allows deductions for investment income earned on and added to reserves in subsequent taxable years, so that the company eventually gets a delayed, but full, deduction.

GAO discounting is a milder assault on the property/casualty industry than is QRA, but it suffers from many of the same flaws.

1. Discounting of loss reserves is inappropriate.

   This has been fully discussed earlier,[24] yet some points should be reiterated. GAO discounting will make loss reserves considerably less accurate than they are now, because it requires correct calculation both of future claim settlement rates and the actual amounts of future claim payments. Although the discount rate used in calculating the initial reserve is a moving average of the last five years' rates of return, additions to the reserve depend on future years' rates of return, which are fed into the moving average. Since these cannot be known in advance, more inaccuracy will be added here. GAO discounting also taxes anticipated income, because it taxes investment income before it is received.

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[24] See pp. 10-13 above.

Nowhere in the Code is income that has not yet been either accrued or received considered to be taxable income, and this novel notion should not be incorporated into our tax law.

2. GAO discounting will damage solvency regulation.

As shown earlier,[25] any discounting system seriously threatens state regulation for solvency. GAO discounting will uncouple statutory accounting from the Code, just as QRA does, and the NAIC's condemnation of QRA applies equally to all forms of discounting.[26] If GAO discounting is ever adopted for statutory accounting purposes, it will have the same detrimental effect on the regulators' ability to preserve company solvency. It will also encourage company underreserving, the single largest cause of insolvency.

3. GAO discounting will be extremely complex.

There is nothing simple about this process. Computation of loss reserves will be complicated, with two new variables (claim settlement rate and discount rate) added. A new set of books for federal income tax accounting will have to be kept. And the expense to companies and the Internal Revenue Service in the auditing of returns will increase enormously. It is difficult enough now for companies and revenue agents to agree on loss reserve audits when all that is being examined is the reasonableness of a company's estimates of actual losses. The IRS would now have two more variables to audit, with a concomitant increase in expense and time.

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[25] See pp. 25-27 above.

[26] Resolution of the National Association of Insurance Commissioners, see p. 26 above.

4. GAO is uncertain about how much revenue it will raise.

The GAO estimates that its proposal would have raised $485-613 million in revenue in 1982. Yet, it cautions that these figures "should not be viewed as a projection of actual immediate yield to the Treasury" because:

(1) higher premiums caused by tax increases would give business policyholders greater deductions;

(2) insurers would almost certainly invest in tax-exempt investments to a greater degree; and

(3) much of the increase would be absorbed by net operating loss carryforwards.[27]

The uncertain amount of tax revenue that might be raised is certainly not worth the practical dislocations and costs to companies, the government and the general public that GAO discounting would cause.

IV. Taxation of mutual policyholder dividends

The President's proposal would reduce the deduction for policyholder dividends allowed to mutual property/casualty companies in a manner similar to the way in which the deduction for policyholder dividends allowed mutual life insurance companies is reduced under current law.[28] All segments of the industry, both stock and mutual, agree that such an approach is totally inappropriate for mutual property/casualty companies, and demonstrates the Treasury's continuing failure to recognize the fundamental differences between life and property/casualty insurance. A policyholder dividend is a

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[27] Congress Should Consider Changing Federal Income Taxation Of The Property/Casualty Insurance Industry, pp. 17-19.

[28] The President's Tax Proposals to the Congress, p. 278.

return payment to a policyholder by an insurer of premiums that are unnecessary to pay losses and expenses. Since all the company is doing is returning unnecessary premiums, it may deduct policyholder dividends from gross income (generally premiums and investment income) for federal tax purposes. Stockholder dividends, of course, are paid only by stock companies and represent the return on a stockholder's investment in the company. Both stock and mutual companies pay policyholder dividends--each segment of the industry paid about $1.1 billion in 1983.

Because mutual companies have no stockholders and their policyholders elect the directors that run the companies, however, the Treasury believes that a portion of the policyholder dividends that mutual insurers pay is a return on investment, similar to stockholder dividends. This is measurable, Treasury believes, by the difference in return on equity ("ROE") between mutual and stock companies. In the life industry, stock companies have traditionally had a higher ROE than do mutuals. This difference is deemed by Section 809 of the Code to represent a return on mutual policyholders' "investments" in their companies, and is used to reduce the deduction for policyholder dividends. This tax, adopted in 1984, is a new tax on all mutual life insurers, because this so-called "ownership differential" between stock and mutual life insurers is deducted from reserves if a company doesn't pay enough policyholder dividends. Despite the tremendous differences between property/casualty insurers and life insurers, the Administration proposal seeks to expand the 1984 law in some unspecified way to mutual property/casualty insurers.

1. What does the Treasury want?

It is entirely unclear in the President's proposal how Section 809 would be expanded to mutual property/casualty companies. Treasury has not contended that after-tax ROE is different between mutuals and stocks in the property/casualty industry. In fact, Treasury has not pointed to anything that would indicate any possibility of mutual "investment return" paid to policyholders in this industry, except for the barefaced allegation that the problem exists. It is very difficult to respond to such a vague allegation.

2. Treasury has again ignored the essential differences between the property/casualty and life industries.

Section 809 was the result of a political decision by the Congress that mutual life insurers ought to pay 55% of the industry's taxes. Mutual life companies write the preponderance of the life industry's business.[29] This concern about "segment balance", an important cause of Section 809, has no place in the property/casualty industry, where stock companies write the great majority of the business and have alleged no competitive inequity. More fundamentally, life and property/casualty policyholder dividends are different. State law generally requires mutual life companies to write participating contracts, in which policyholder dividends are required. Stock life insurers generally do not write such contracts. In contrast, stock and mutual property/casualty companies pay essentially the same amount of policyholder dividends by segment, and nearly 65% of the dividends are paid in one line -- workers compensation. If all mutual policyholders are entitled to investment return, why do only the workers compensation policyholders get it?

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[29] General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Congress; Public Law 98-369), Joint Committee on Taxation, December 31, 1984, pp. 612-613.

3. Property/casualty insurance is protection, not an investment.

Treasury has missed another fundamental difference between life and property/casualty insurance -- there is no investment aspect to a property/casualty policy. Policyholders buy auto, fire, homeowners, and workers compensation coverage for protection, not as an investment. Workers compensation policyholders, who receive 65% of property/casualty policyholder dividends, probably comprise less than 5% of total property/casualty policyholders. Most dividends paid to workers compensation policyholders are currently computed on a "sliding scale" or "loss sensitive" basis. In other words, the lower the losses, the greater the dividend. Clearly, these indicators do not reflect a distribution of earnings to owners, but rather a return of premium to those policyholders who can significantly reduce losses by the implementation of sound safety procedures.

4. A new tax on all mutual insurers.

This proposal is a new tax on all mutual insurers, despite the Treasury's talk about a "limitation" of the policyholder dividend deduction by the amount of the "ownership differential." Section 809 goes beyond the reduction of policyholder dividends by actually reducing the closing balance of a company's life reserves where the differential earnings amount exceeds the allowable policyholder dividend deduction. Many mutual property/casualty companies do not now and never have paid policyholder dividends. Treasury has alleged no justification for forcing such an insurer to reduce its reserves in this fashion.

There has been no demonstration that the rate of return on net worth is meaningfully different between stock and mutual property/casualty insurers. Nor has there been any demonstration that stock companies pay a disproportionate share of property/casualty taxes. Any effort to impose a tax similar to Section 809 on this industry should be rejected.

V. Abolition of the "protection against loss" account.

Congress created the Protection Against Loss ("PAL") account in 1963 when it unified the tax system for stock and mutual property/casualty companies. It recognized that mutual companies, unlike stock copanies, cannot sell their own stock to raise capital needed for growth and protection against future catastrophic losses. The PAL account was created to help even the balance. The account essentially allows mutual insurers to defer federal taxes on 1% of incurred losses and 25% of underwriting income for five years, at which time the deferred amount (except for half of the 25% of underwriting income) is returned to taxable income. If a company suffers tax losses in intervening years, however, the losses must be offset with amounts carried in the PAL account. Because of the industry's horrible financial results in recent years, most mutual property/casualty companies no longer have PAL accounts, because they have been exhausted to pay losses. Most of those that still have PAL accounts tend to be small, more profitable and payers of large amounts of taxes. The Treasury and the General Accounting Office, and now the President, think the PAL account should be eliminated. This is wrong because:

1. PAL has helped mutual companies to build the capital necessary to protect them against unanticipated and catastrophic losses. These companies do not have the advantages of diversification of risks and great geographic spread that larger companies have, and PAL is especially valuable to them. They also provide the bulk of insurance protection for rural America. PAL also aids market entry by helping small mutual companies to increase their premium writings without putting unsafe pressures on their policyholders' surplus, as shown in Appendix IV. PAL has helped them to keep their premium/surplus ratios down while increasing their market shares.

2. Elimination of PAL would raise very little revenue. As mentioned above, in order to have a PAL account, a company has to have underwriting income, which few mutuals have had in recent years. As a result, few companies have PAL accounts. Those that do tend to be the small companies that need it most.

3. Congress' purpose in creating the PAL account has been served. Both mutual and stock companies are united in supporting the PAL account. Although Treasury and GAO claim that PAL is inequitable to stocks, the stock industry itself refutes that argument.

VI. Abolition of the small mutual company deductions and exclusions.

Congress and the Internal Revenue Code have long recognized the importance of the small mutual property/casualty insurance companies, primarily farm mutuals, that provide the major source of insurance protection for America's farming communities. The most important provisions in the Code specifically concerning these companies, last revised in 1963, currently exempt mutual companies with gross income of $150,000 per year or less from federal taxation. Companies with gross income exceeding $150,000 but not exceeding $500,000 may elect to be taxed only on investment income. Other provisions lower the tax rate on investment income or taxable income under certain circumstances. The President's proposal would eliminate these provisions, and is wrong for the following reasons:

1. Farm mutual companies, limited to writing in one country or contiguous countries, are the backbone of insurance protection for agricultural America. Large, multi-line companies tend to move into and out of farm markets, but the farm mutuals are always there.

2. Farm mutuals face the competitive disadvantages of a highly-geographically concentrated book of business,

the unavailability of economies of scale and the lack of ability to spread risks among large numbers of policyholders, and high reinsurance costs. They also need a lower ratio of premiums to surplus, to protect against catastrophic losses, than larger companies need.

3. The small mutual exclusions and exemptions, together with the PAL account, enable farm mutuals to raise the capital they need to protect American agriculture. With the agricultural and rural economy under the massive strains to which they are currently subject, this is hardly the time to pull the rug out from under their insurance protection.

VII. Taxation of workers compensation benefits

Although the Administration's proposal to tax injured workers on their workers compensation benefits is not a direct tax on property/casualty insurers, we would like to comment on it as well. This proposal is as ill-advised as the others we have commented upon, for the following reasons:

1. It is unfair to injured workers. It is unfair to injured workers and their families to tax their benefits, which are at most in any state 66-2/3% of their pre-injury wages, and out of which attorney's fees and other expenses must be paid, at the time that they need them more than ever. The National Council of Compensation Insurers has estimated that an injured worker with a spouse and one child would lose, on the average, 14% of his or her indemnity benefits -- approximately 9% of total benefits--from federal taxation alone.[30] Since most states with income taxes are linked with the Code, the loss of indemnity benefits caused by federal, state and local taxes would be 19% -- a loss of 12% of total benefits.[31] Many states already take income tax withholding into account in reducing their benefits, and this further slash is simply unconscionable. It is also unfair that, while Treasury would tax compensation benefits, another person with the same injury suffered outside work

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[30] Taxation of Workers Compensation Benefits, National Council on Compensation Insurance, June, 1985, p. 3.

[31] Taxation of Workers Compensation Benefits, p. 4.

would pay no tax on any of the tort benefits received, tort benefits for which a compensation beneficiary cannot sue.

2. It will increase the costs of American business. States will be strongly pressured to increase their benefit levels. NCCI figures show that a 15% rate increase would be needed by insurers to provide the same benefits.[32] Rate increases must be approved in most states by the insurance commissioner. If they are not approved, companies may leave the workers compensation market. Since tort plaintiffs are not taxed on personal injury recoveries, attacks on the exclusiveness of the workers compensation system will be exacerbated, further increasing the costs of the system. At a time of unprecedented trade deficits, it is hardly advisable to increase the cost of doing business in the United States, yet this is exactly the effect of this proposal.

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[32] Taxation of Workers Compensation Benefits, p. 4

3. The states, which can respond quickly to changing local conditions, are best qualified to determine the appropriateness of benefit levels. The Treasury's proposal attempts to alter them by federal tax policy, a peculiarly inappropriate tool. No allowance is made, for example, for those states that calculate benefit levels on an after-tax basis. The states, not the federal government, are best equipped to determine what is fair for their workers and what incentives will induce injured employees to return to their jobs.

IX. Conclusion

The Administration and GAO proposals bring many intolerable consequences in their wake, and exhibit their fundamental misunderstanding of the insurance industry. Those who value a strong American economy and the financial protection that the property/casualty industry provides should reject their proposals.

APPENDIX I

IMPLICIT TAX PAID BY INVESTING IN NONTAXABLES
(DOLLARS IN MILLIONS)

YEAR	NONTAXABLE ASSETS	NONTAXABLE YIELD	NONTAXABLE INVESTMENT INCOME	TAXABLE YIELD	INVESTMENT INCOME AT TAXABLE YIELD	IMPLICIT TAX PAID (INVESTMENT INCOME LOST)
1983	$86,668	4.9%	$4,216	7.8%	$6,747	$2,532
1982	$86,968	4.7%	$4,082	8.0%	$6,982	$2,900
1981	$83,917	4.5%	$3,763	7.9%	$6,651	$2,887
1980	$79,994	4.1%	$3,267	7.1%	$5,711	$2,444
1979	$72,113	3.7%	$2,642	7.0%	$5,045	$2,403

Original research from Alliance of American Insurers Research Department, using data from Corporation Source Book of Statistics of Income, U.S. Department of the Treasury, Internal Revenue Service, various years, and Aggregates and Averages, A. M. Best Company, Oldwick, New Jersey, various years.

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APPENDIX II

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Financial News | Washington Review | Perspectives | On-Line Reports

The Effect of the Treasury's Tax Reform Proposals on the Property/Casualty Industry

Much has been written concerning the Treasury Department's proposals to restrict, by discounting estimated future losses to present value, the amount of funds that insurers can place in tax free reserves. Touted by the Treasury as a way to recognize the time value of money and to eliminate unfair advantage over self-insurers, these tax proposals have been roundly criticized by property/casualty industry spokesmen as undermining both the philosophical and financial footings of the industry.

Until now, little has been published on the extent of the potential damage to insurers in dollars and cents or to outline the full ramifications to the individual insurer, the insurance consumer, the insurance industry and the U.S. economy should these tax proposals become part of the law of the land. In this article, Robert A. Bailey, Vice-President of the Property/Casualty Division of the A.M. Best Company, follows a line of analysis that describes the negative effects such laws would have on a business already reeling from a period of declining returns.

Throughout this paper, QRA means Qualified Reserve Account and is defined as an insurer's estimated amount of loss reserves, discounted to present value at the after-tax yield on the company's investments.

Premise: If the Treasury's proposals for "Qualified Reserve Accounts" (QRAs) were adopted without any other change in federal tax law,* the increase in federal taxes on the U.S. property/casualty insurance industry is estimated to be equivalent to 8% of earned premiums each year. To compensate for lost income, increases in premiums, varying by line of business, would be required. Such premium increases are estimated at 32% for medical malpractice, 24% for general liability, 15% for workers' compensation and reinsurance—an overall average rise of 11% for the industry.

How the Proposed QRA Method of Taxing Property/Casualty Insurers Would Work

If the Treasury's proposed tax laws were enacted, an insurer would be required to establish a QRA for each line of business for each policy year, receiving a deduction from taxable income only for the discounted present value of the estimate of future losses. Loss payments would be deducted from the QRA and consequently would not generate a deduction from taxable income unless the QRA is exhausted and could not be used to offset the loss payment. Each QRA would be increased annually by a percentage equal to the after-tax rate of return actually earned by the company on its investments during that year. These additions to QRAs from investment income would not be deductible from taxable income.

The company would be free to use any method to estimate and discount its loss reserves but would be limited to a maximum initial QRA equal to premiums earned less sales and administrative expenses incurred and less policyholder dividends incurred.† The Treasury would not need to be concerned if the initial QRA was excessive, since the excess amount, together with the annual increases from the after-tax investment return would be added to taxable income when the QRA is closed out. Since any difference between the initial loss estimate and future losses would be adjusted for interest, the present value of the difference would not be affected. Consequently, the segregation of QRAs by line of business would be administrative only and would have no bearing on the present value of the QRA's effect on taxes.

To estimate the potential effect of the proposed QRA method of tax reform, it will be assumed that every company will set up the maximum QRA in order to minimize dependence on carryback provisions of the tax code (due to limitations on these carrybacks).

Effect of Treasury's QRA Proposal

The immediate effect of the QRA method would be an increase in taxable underwriting income equal to the difference between incurred losses on an undiscounted basis and incurred losses discounted at each insurer's after-tax investment yield. This is actuarially equivalent to the difference in taxable income figured on a paid basis versus an incurred basis. The difference in both cases is equal to the present value of the interest on the loss reserve for the average length of time the loss reserve is outstanding, which is in turn equivalent to the discount on the loss reserve. For the industry as a whole,

(continued)

the Treasury's QRA proposal would increase taxable income by 12% of incurred losses annually, regardless of the accuracy of the initial reserve.

For all lines of business combined, the average length of time between the date that losses are incurred and the date they are paid is about two years. The average after-tax rate of return on investments is about 6%. Therefore, the effect of the QRA would be an increase in taxable income of about 12% of incurred losses.

For the industry as a whole, the average ratio for underwriting expenses and dividends to premiums is about 30%, leaving 70% of premiums for the present value of losses and loss adjustment expenses. Consequently, the increase in taxable income would be 12% of 70%, or about 8.4% of premiums. Assuming the current tax rate of 46%, the increase in taxes would be 46% of 8.4%, or approximately 4% of premiums for all lines of business combined. (If the general corporate tax rate were reduced to 33%, the tax increase would be about 3% of premiums.)

If the initial QRA is too high or too low, the correction is deferred, but with interest. If the insurer and its affiliates are not in a taxable position and have enough tax loss carryforwards to cover the additional taxable income, the additional tax would be deferred without interest. But the addition to taxable income would be so substantial, especially in the case of the commercial lines carriers, that reduction in the effective tax rate would be relatively small due to deferral, at least after the new basis has been in effect for a year or two.

The 12% increase in taxable income would effectively accrue for each year regardless of fluctuating underwriting results, even though it may take several years until the full tax increase effect emerges. The effects of the QRA proposal on industry taxation for two highly contrasting years—1983 and 1979— are compared below:

In 1983, the industry aggregate incurred losses and loss adjustment expenses for accident year 1983 were $88.2 billion ($87.4 billion for all accident years combined). Premiums earned less underwriting expenses incurred and dividends to policyholders incurred equaled $73.6 billion. If a QRA of $73.6 billion had replaced the undiscounted incurred losses of $88.2 billion, the increase in taxable income would have been $14.6 billion, and at a corporate tax rate of 46% the increase in taxes would have been $6.7 billion, ignoring the effect of tax loss carryforwards. (At a tax rate of 33%, the tax increase would be $4.8 billion.) Since $14.6 billion is more than 12% of $88.2 billion (it is 16.6% of $88.2 billion), the QRA for 1983 may have been deficient. That deficiency, with interest, would have emerged in subsequent years. Therefore, the present value of the ultimate tax-raising effect of the QRA method on 1983 is probably about $10.6 billion (12% of $88.2 billion) of taxable income and $4.9 billion in taxes ($3.5 billion in taxes at a tax rate of 33%).

In a year like 1979 when the combined ratio was about 100% using undiscounted loss reserves, the QRA would have equaled the undiscounted loss reserve, so the immediate tax effect would have been zero. But such a QRA would have been excessive, and the excess, with interest, would have eventually been released into taxable income. Therefore, the present value of the ultimate QRA proposal would still be 12% of expected losses (multiplied by the tax rate), even though several years would elapse before the full tax increase effect would emerge.

The QRA proposal is in effect not income tax reform but rather a "premium" tax, the effect of which radically differs according to each line of business with its characteristic pattern of loss reserves. The average premium tax would be equivalent to 4% of premiums for all lines—as much as 14% for medical malpractice.

The scenarios that follow below show how insurers would be liable for taxes that have little relation to actual economic income:

- If a company operated at an economic gain of zero before taxes using the full investment income to offset underwriting losses based on undiscounted loss reserves, and if all its investment income were taxable interest, the effect of the QRA method would be to subject all of the investment income to tax. This would result in a substantial tax even though economic income was nil and would cause a net loss after taxes. **In this case, a tax would be imposed even though no economic income existed.**
- If a company operated so that its economic gain was equal to the tax on its taxable investment income, using its investment income after taxes to offset the underwriting losses based on undiscounted loss reserves, the effect of the QRA method would be to impose a tax equal to 100% of the true economic gain of the carrier, resulting in net income after taxes of zero. **In this case the effective tax rate would be 100%.**
- If a company operated with an economic gain before taxes that exceeded the tax that would be imposed solely on its investment income, the QRA method would impose a tax equal to normal tax rates on the true economic gain reduced by tax-exempt investment income, **plus an additional tax on the discount on loss reserves figured at the after tax yield on investments.**

In summary, the QRA proposal is not an income tax reform. It is a "premium" tax that varies by line of business according to the relative amount of loss reserves generated by each line of business. This federal premium tax is coordinated with the income tax so that any tax loss carryforward generated by the income tax can be applied against the premium tax, but the premium tax is not a deduction from taxable income for calculating the income tax. The average premium tax would be equivalent to approximately 4% of premiums for the overall industry, 14% for medical malpractice insurance, 9% for general liability and 6% for workers' compensation and reinsurance (assuming no change in the corporate tax rate).

These premium taxes would not be recognized in determining income subject to income tax. To provide for a new premium tax of 14% on medical malpractice, premium rates would need to be increased about 32% to produce the same profit margins as at present. The 32% increase would cover the 14% premium tax, 6% for additional commissions, state premium taxes and other overhead expenses, and an additional 12% to cover income taxes (at a 46% rate) on the 26% addition to taxable income. Similarly, workers' compensation rates would have to be increased about 15% to cover the estimated 6% new premium tax, 4% for additional commissions, state premium taxes and overhead, and 5% for income taxes on the 11% addition to taxable income.

How the QRA Proposal Would Impact the Insurance Industry and Ultimately the U.S. Economy

> Premiums charged insureds by the property/casualty industry would need to be increased approximately 11% annually to cover the increased taxes and additional expenses.

Because insurers would probably be unwilling or unable to operate with a reduction in after-tax net income in an amount equal to 4% of premiums, competition would force an increase in premiums sufficient to make up the difference. The increase in income would lead to an increase in income taxes beyond the tax increase generated by the QRA method. At the present corporate tax rate of 46%, the additional increase in taxes would be almost 4%. Therefore, the full effect of the QRA method, if there is no concurrent corporate tax reduction, would be an increase in federal taxes equivalent to 8% of premiums each year, half from the QRA itself and half from the increase in taxable income necessary to provide 4% of premiums for the QRA after taxes. To provide an additional 8% of premiums for taxes would require an increase in premiums of more than 8% (approximately 11%) to cover additional expenses.

> **This increase in taxes and the subsequent necessary increase in premiums charged insureds would make it impossible for the long-tailed lines of business to compete effectively, squeezing them out of the U.S. insurance market.**

The effect of these new premium taxes and associated rises in other expenses and income taxes would force most of the long tailed lines of business out of the U.S. insurance market. This would be especially true of medical malpractice, commercial liability, workers' compensation and reinsurance. Such lines would be forced to go offshore where lower tax burdens would make it possible to keep premium rates competitive. These lines of insurance would take with them vast amounts of financial assets, adversely affecting the U.S. balance of payments and the general economy, as well as the U.S. insurance industry.

> **The property/casualty industry's traditional, conservative pattern of investment could be altered.**

The QRA proposal would create strong financial incentives for insurers to place their investments in non-income producing investments like growth common stocks. If an insurer's after-tax return on its investments were zero, it would not have to discount loss reserves and would have no increase in taxes from the QRA method. A shift into low yield equities and out of fixed income securities would have further negative effects on the securities markets and on the financial stability of the insurance industry.

> **State and local governments could find it more difficult to finance needed projects if the insurance industry withdrew from investment in tax exempt bonds.**

Tax reform via the QRA method would eliminate any incentive for the property/casualty insurance industry to invest in tax exempt bonds, since the higher after-tax yield of tax exempt bonds would produce a corresponding increase in federal taxes. The QRA method would make the effective after-tax yield virtually the same for both taxable and tax exempt bonds. Taxable bonds would be favored because, in addition to having the same after-tax yield, they would provide a much greater yield in the event that underwriting losses eliminated the tax on investment income. The disappearance of the vast assets of the property/casualty insurance industry from the market for tax exempt securities would have significant effects on the costs of financing state and local governments and on the tax exempt yields obtainable by other investors.

What the Treasury's QRA Tax Reform Proposal Overlooks About The Basic Nature of the Insurance Industry

- **Insurance is a business:** To disallow tax deduction for future losses at the time of contract disregards a sound business tenet that strives to minimize future risk by quantifying it and preparing financially for it today. To force a business into an uncompetitive stance by such a disallowance is to ignore the fact that insurance, like any business, must make money to justify its corporate existence.
- **Insurance provides security against risk and uncertainty:** To place financial penalties on the accumulation of funds in advance to assure payment for accidents and catastrophes ignores the value of the security that insurance provides.
- **The value of insurance is in reducing the cost of risk and uncertainty:** To impose a burden on the insurance industry in proportion to the relative risk of each line of insurance and its characteristic length of time between payment of premium and payment of loss results in significantly higher cost of risk

(continued)

to insureds. This counteracts one of the fundamental purposes of insurance, which is to reduce the cost of risk to the insured in a free enterprise society.

- The U.S insurance industry competes in an open-ended world market: To place substantial tax burdens on U.S. insurers that exceed those imposed in other countries ignores the fact that U.S. insurers must keep a strong financial footing in order to maintain their position in an increasingly competitive world insurance market.

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[*] *It has also been proposed that the general corporate tax rate be reduced from the current rate of 46% to 33%. If this proposal is accepted, the tax-raising effect of the QRA method of discounting reserves would be reduced correspondingly. Although this study predominantly focuses on the results of a single piece of proposed tax legislation (the establishment of QRAs), brief commentary on the combined effect of a simultaneous enactment of a QRA proposal and a change in the general corporate tax rate is offered at appropriate points throughout the text.*

[†] *The Treasury's proposal is still vague and does not specifically mention policyholder dividends or loss adjustment expenses. It has been assumed here that policyholder dividends would be included with sales and administrative expenses and that loss adjustment expenses would be included with losses.*

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APPENDIX III

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QRAs Analyzed —
Consensus: Unfair to Insurers and Policyholders

With Congress making progress toward adoption of some form of tax reform, possibly before the end of the year, much attention is being focused on the several provisions which will affect the business of insurance. For the property/casualty side of the business the proposal getting most attention is the QRA (Qualified Reserve Account), which would deny p/c insurers the freedom to accumulate reserves on a fully tax-free basis.

The following are three commentaries on the QRA proposals, each looking at the ramifications from a slightly different viewpoint. Each of the three contributors concludes that adoption of a QRA provision in a new income tax law would be unfair to the insurance industry and its customers, the policyholders.

"...not equivalent to discounting...equivalent to cash accounting."

(excerpts from a report to the American Academy of Actuaries by its Committee on Financial Reporting Principles, for presentation to Congress)

Highlights of the Proposal

Deductions for unpaid losses and unearned premium (for tax purposes) would be computed under the "Qualified Reserve Account" (QRA) method. A QRA would be established by line of business and policy year. It is intended that the initial QRA, established at the time the policy is written, be equal to the present value of estimated claims, discounted at the estimated *after-tax* rate of return. (However, there will be *no formal limitations* on the method used to establish QRAs beyond a limitation that the initial QRA cannot exceed statutory reserves.)

The QRA would replace the unearned premium and loss reserves. Essentially, the QRA can be viewed as a "policy reserve," covering both the unearned premium and loss reserve liabilities.

Each QRA established by the company would be increased annually by the company's *actual* after-tax investment rate of return on total assets. However, no additional deduction would be allowed for these increases.

Companies would pay their claims and reduce their QRA accordingly. If the QRA were exhausted by claim payments, the excess payments would be fully deductible when paid. If, after all claims were paid, any funds were left in the QRA, these funds would be released and included in taxable income at that time.

A company would be permitted to strengthen its QRA reserves if the company could "show by objective factors" that its reserves were inadequate. A deduction would be given for these additions.

The after-tax rate of return used to compute QRA additions is calculated by:

$$\frac{\text{Net Investment Income (Including Tax-Exempt Income)} - \text{Taxes Attributable to that Income}}{\text{Mean Assets}}$$

To obtain the numerator, a company would apply the appropriate tax rate to each category of investment (taxable investments, dividends, tax-exempts, etc.) and deduct the total indicated tax from total investment income. Nominal tax rates would be used in this calculation, regardless of the actual taxes finally paid by the company.

QRAs would not exist indefinitely. Rules would be established limiting the maximum life of the QRA, depending on the line of business. At that point, the QRA remaining would be released to income. Subsequent claims, if any, would be deductible when paid.

The QRA proposal would apply to A & H reserves of life companies, as well as property/casualty companies.

The QRA approach would be applied to policy years 1986 and subsequent. Prior years would run off (somehow) under current tax procedures.

Public Policy Issues

The administration's tax proposals are intended to promote fairness, growth, and simplicity. It is the stated intent of the proposals to eliminate, to the fullest extent possible, the use of the tax laws to promote public policy objectives.

In the context of property/casualty insurers this premise is reflected, through the QRA proposal, in an effort to achieve some parity between insured and uninsured losses. In general, non-insurance companies are not permitted to deduct estimated losses until those losses properly meet the "all events" test. This test imposes on non-insurance companies something very close to cash accounting. The QRA proposal has essentially the same effect on property/casualty insurers. It is not within the scope of this review to discuss the appropriateness of the administration's objective either generally or specifically as it relates to the QRA proposal for property/casualty insurers; nor is it within the scope to evaluate the objections that are being raised to the QRA

(continued)

proposal. However, arguments are being made against the administration's proposal on various grounds. For example, it is argued that the industry can't afford additional taxation at this time. It has been suggested that the proposal will make domestic insurance uncompetitive with foreign insurance, thereby forcing business currently written domestically to move offshore.

Opponents of the QRA proposal have argued that it will create an actual disincentive to the insuring of risk, with accompanying adverse social and economic consequences. Furthermore, they argue that the QRA proposal will not succeed in putting property/casualty insurers on the same footing as non-insurers. They point out, for example, that non-insurers are not required to pay any state premium taxes, thereby giving non-insurers a built-in cost advantage over insurers. Similarly, property/casualty insurers will still not be allowed to fully consolidate with life insurers for tax purposes.

Most of the arguments, pro and con, address public policy issues, or the tax and economic costs of implementation. Since these arguments are clearly an important part of the debate, they have been briefly outlined.

The Key Issue

Fundamentally, the underlying tax issue can be reduced to very simple terms illustrated by means of an example: consider a single policy written under the following circumstances:

- A $100 loss will be paid after two years.
- There are no expenses.
- The taxable interest rate is 10%.

Suppose the company prices the policy so that it exactly breaks even. It charges a premium of: $\$100.00 \div (1.10)^2 = \$82.64$

Under this policy the company achieves no economic gain. The full investment income at 10% is required, along with the premium, to discharge the $100 obligation. Under such circumstances it is reasonable to argue that no income tax should be paid.

However, the administration's proposal would impose a tax in this situation. The argument would be that an *individual* taxpayer would be required under current tax law to pay taxes on the interest income during the two year holding period.

To put the property/casualty industry on the same footing, it also should pay taxes on the interest income. The administration's argument would be that the present value of the $100 obligation using the *after-tax* rate is the economically neutral premium.[5] In our example, this premium is (assuming a 33% tax rate): $\$100.00 \div (1.067)^2 = \$87.84$

It should be seen that, like the key issue confronting the life insurance industry, the issue confronting the property/casualty industry reduces to the question of the tax treatment of the *internal build-up of interest income.*

Comparing the $82.64 premium computed at the pre-tax rate with the $87.84 premium computed at the after-tax rate, it is being argued by the Treasury that the *higher* price represents the "no income" alternative.

Summary of Key Observations

Based on our analysis...we would draw the following key conclusions:

- The QRA Method is *not* equivalent to discounting. It goes much further than previous tax reform proposals. Under certain assumptions the QRA Method is equivalent to cash accounting. While this is true in very simple cases, when more complicated examples are considered, the equivalence to cash accounting is lost.
- The QRA proposal does not require that reserves be discounted. Under the proposal, companies could continue to set reserves on an undiscounted basis. These reserves would grow with interest, in theory becoming redundant. The release of this redundancy would be a taxable event. However, the proposal does encourage discounting by imposing penalties for "over-reserving" in some cases.
- The QRA proposal has the appearance of imposing taxes on tax-exempt income. This is a subtle, but logical, coroliary to the Treasury's position on internal build-up of interest income. The tax-exempt interest income is not taxable directly under QRA. However, the "underwriting profit" that results from the present value of the insurance cash flow discounted at the tax-exempt rate is taxable.
- Under current tax law the traditional investment strategy is to invest in taxable investments in an amount sufficient to offset underwriting losses, with the balance of investments in tax-exempts. (This assumes that the after-tax yield on taxables is lower than the yield on tax-exempts.) Under the Treasury proposal there will no longer be large underwriting losses, as the underwriting result is essentially calculated on a present value, rather than a nominal value, basis. In the absence of these underwriting losses the industry will probably find it desirable to shift back out of taxable investments and return to an investment policy that concentrates on tax-exempt investments.

"...will eliminate reserves; is hostile to private insurance..."

(comments by Robert A. Bailey, vice president, A.M. Best Company)

The Treasury's tax proposals for property/casualty insurers—particularly the QRA provision—will raise taxes on insurers substantially. But far more threatening in the long run than the tax increase will be the displacement of a private domestic insurance market in commercial lines and reinsurance.

The tax impact will be greatest on long-tailed lines. I estimate the premium increase necessary to maintain present after-tax margins will be about 32% for medical malpractice, 24% for general liability, and 15% for workers' compensation and reinsurance. These increases are based on a corporate tax rate of 46%. If the corporate rate is reduced, the increases required would also be reduced, but they would still be substantial. Increases of any significant size will substantially accelerate the trend toward reinsuring greater proportions of U.S. business with offshore reinsurers.

In addition, medical malpractice and workers' compensation will move, in my opinion, toward monopolistic state funds. A state with a monopolistic state fund could provide the same benefits at less than half the cost of neighboring states that rely on private insurance. The state fund would have three advantages—no taxes, no reserves for unpaid claims, and no actuaries to estimate what the reserves and rates should be. The state funds would operate on a cash basis—the same basis that underlies the Treasury tax proposals.

The aspect of the Treasury II proposal most fundamentally in opposition to basic insurance principles is its clearly stated objective to tax an insurer on the same basis as if it did not carry any reserves for unpaid claims. The result, if enacted, will be to eliminate reserves. And because private insurance cannot operate without reserves, private insurance will be replaced with alternatives that either eliminate the reserves or move them offshore where they are recognized as necessary for the business of insurance. Treasury II is fundamentally hostile to private insurance.

"...the industry would have to increase rates 8%..."

(Results of formulas and calculations created and performed by Joseph W. Levin, vice president and actuary, Employers Reinsurance Corp. Mr. Levin determined payout factors from industry Schedules O and P, applied annual interest rates, determined expense ratios and calculated percentage increases in premiums needed to offset loss of income arising from the QRA proposal. By major line of business, the following table shows rates of premium increases needed to maintain present margins, assuming an annual after-tax investment income rate of 6% on investment.)

Line of Business	at 33% tax rate	at 46% tax rate
Auto Liability	7.5%	15.1%
General Liability	15.2%	32.6%
Medical Malpractice	17.1%	31.8%
Workers' Compensation	10.6%	20.5%
Total - all lines	8.0%	17.2%

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Church Mutual
Insurance Company

APPENDIX IV

March 1, 1984

3000 Schuster Lane
P. O. Box 357
Merrill, Wisconsin 54452
Ph. (715) 536-5577

Alliance of American Insurers
ATTN: Richard Hefferan
1501 Woodfield Road, Suite 400 West
Schaumburg, IL 60195-4980

Dear Mr. Hefferan:

It is my understanding that the General Accounting Office has taken the position that the Protection Against Loss Account, known in the industry as the PAL Account should be removed as part of a program to raise additional federal income tax revenue from the property and casualty insurance industry. In my opinion this would be a terrible mistake, and quite detrimental to the small, growing property and casualty insurance companies. I'll use Church Mutual as an example, but I believe the principle applies to most of the smaller, well managed companies in the industry.

First of all, I have an observation which I would like to share with you. I believe you will find, upon studying the issue, that those companies which have active PAL Accounts are currently paying substantial federal income taxes. As you can see from my attached chart, our relatively small company has incurred $10,271,675 in federal income taxes since 1971, when I became associated with the company. The PAL Account has allowed us to defer an additional $1,315,000 (cumulative) in taxes during this period. If it is the intent of Congress to obtain additional tax revenues from the insurance industry, it seems to me that its attention should be focused not on the companies who are already paying substantial taxes, but rather on those which are not.

The PAL Account has definitely been of great assistance to Church Mutual in the past twelve years. Our company specializes in insuring churches and other religious properties, and we have had a good rate of growth. Attached for your information is an exhibit illustrating the growth of the Church Mutual PAL Account since 1971 and through 1983. I have also included columns for direct premiums written, policyholder surplus and federal taxes incurred. Next to the PAL Account I have indicated the amount of that account as a percentage of policyholders surplus. I recognize that the Protection Against Loss Account is a liability and has nothing to do with surplus, except that the chart shows that we as a company have been able to defer substantial taxes during this period and that such deferral, each year, ranged between 4.7 and 6.8 percent of our policyholder surplus. The dollars in the PAL Account are invested by the company and contribute to surplus gains. I put the direct premium figures in to illustrate that there were a number of years when our surplus increase did not track with our increase in direct premiums written, especially in the early years when we were growing faster. In 1973, for example, our premium grew 15.1% and our surplus only 6.2%. In 1974, the premium growth was 13.6% and surplus growth only

2.5%. In 1976, premium grew 32.9% and surplus 22%. In 1977, the figures were 34.4% and 22.7% respectively. As you well know, an insurance company can get itself in financial trouble rather quickly if it grows too fast. Having the additional cushion of the PAL Account to guard against catastrophe during this period of high growth was especially helpful.

As you know, a mutual insurance company cannot go to the equity market to raise capital as can a stock company. The deferral of federal income taxes in our PAL Account helped support our rapid growth during the mid 1970's.

The Protection Against Loss Account, for us, has provided us with additional security and allowed us additional investment income to apply towards surplus growth during these years when we were expanding rapidly.

Mr. Hefferan, I have one additional observation. It is my belief that the PAL Account is especially important to the small, growing mutual insurance companies. To eliminate the account for them would raise little revenue, but might jeopardize their security, and certainly could inhibit their growth. This, I believe, would be counter-productive to anything Congress might be trying to accomplish in the area of revenue enhancement.

I trust that this letter will clearly explain the need for the retention of the PAL Account, at least for small to medium sized property and casualty insurance companies, but should you have any additional questions, Mr. Hefferan, please do not hesitate to contact me.

Sincerely yours,

Dieter H. Nickel
President

DHN/lls
Attachment: PAL Exhibit

The CHAIRMAN. Senator Long.

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, I will address Mr. Osborne and Mr. Mitchell primarily. Under current law, we have a small property and casualty company provision. And under both the President's proposal and the Ways and Means' proposal, that would be repealed. As I understand the history of that provision, those exemptions—mutuals less than $150,000 and so forth—were put into the law because of the relative lack of availability to insurance in rural areas. Is that correct so far?

Mr. OSBORNE. Yes, Senator, that's correct.

Senator HEINZ. To what extent is that still a problem? And to what extent was that provision to be agreed upon by everybody? Would it create a lack of insurance in rural areas?

Mr. OSBORNE. Senator Heinz, that provision went into the code in, I think, 1962, as I referred in my previous testimony. One of the problems in the farm community today is the availability of insurance. I might speak to that in our own geographical area because we've had quite a few of the larger companies close their Portland offices or down staff them significantly. And I don't mean that they pull out of the State, but for economies they centralized. But it does and is bringing an increased pressure on the local companies, such as ours and these small companies, who today are the only markets available. My concern is that the elimination of them, of this exemption, would further restrict the market.

I did say in my testimony, however, that realistically that was a 1962 figure, and when you look at the inflation rate, of course, that hasn't been adjusted since that time.

The answer to your question, availability is critical, and this exemption is necessary if these people are going to compete. Many of these people are in one county or contiguous counties and some operate just in a township. I know companies with $175,000 of premium. That's hard to imagine. But that's for their policyholders in that area. And catastrophe is a big problem to those companies because of that concentration.

Does that answer your question, sir?

Senator HEINZ. Yes.

Mr. Mitchell.

Mr. MITCHELL. Yes, Senator, I would add that in Pennsylvania, in the Commonwealth of Pennsylvania, there are many companies of that very nature that operate within a township, within a county, that do an excellent job. They know all of their policyholders by their first name, which our company has about 500,000 policyholders and I certainly don't intend to ever try that. But those companies do an excellent job of insuring their neighbors. And I have not heard of any of the larger companies that for competition reasons feel that they should be put out of business.

Senator HEINZ. But if we repealed the 1962 provision, what would happen?

Mr. MITCHELL. They would suffer. They would suffer from a surplus point of view. And they must maintain, like any insurance company, $3 in premium to $1 in surplus. If they exceed that, if they write more premium, or if their surplus drops as a result of further taxation, then their availability is going to dry up. They are not going to be able to insure as much as they do at the present time.

Senator HEINZ. Obviously, in general, but in specific terms, would that happen? Do they have healthy surpluses or not?

Mr. MITCHELL. Many of them have healthy surpluses, yes. But they are not—they do not have surplus surplus. [Laughter.]

Mr. OSBORNE. That could be said of many of us. [Laughter.]

They are extremely fragile and susceptible to catastrophe losses that could just totally wipe them out.

Senator HEINZ. Mr. Nutter, do you have anything to add?

Mr. NUTTER. Just an additional comment. The National Association of Insurance Commissioners supervises and watches the financial statements of insurance companies. I think at this time the NAIC a record number, over 400 companies, that are on its watch list because of concern about solvency. An additional tax that would come directly out of is going to certainly accelerate that concern.

Senator HEINZ. Thank you.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Mr. Mitchell or Mr. Nutter, either one, can you tell me what the effective tax rate was for the typical property and casualty company last year?

Mr. NUTTER. I'm not sure there is a typical property/casualty insurance company.

Senator BENTSEN. Well, there is a median, so if you would give me that please. The industry must have that.

Mr. NUTTER. I'm sure that we can supply that for the record.

Senator BENTSEN. Mr. Mitchell, do you have it?

Mr. MITCHELL. I think I'm getting it, Senator.

Senator BENTSEN. All right, while you are looking for that, then, let me ask you the next question, Mr. Nutter. You mentioned in your statement about the substantial losses in the property and casualty companies last year. And I recognize that. On the other hand, I'm advised that in most instances the investment income did very well and more than covered the losses. Is that correct or not?

Mr. NUTTER. Mr. Bentsen, generally that has been true, but in 1984 investment income did not cover the underwriting losses and was deficient in the neighborhood of $4 billion in 1984 alone. But generally that has been true over a long period of time.

Senator BENTSEN. Four billion. So you do have that figure.

Mr. NUTTER. My recollection is that the underwriting losses for the industry were $21 billion and the investment income was seventeen point something billion dollars.

I also notice from my notes, Mr. Bentsen, that the effective tax rate as a percentage of economic income for the industry, including tax-exempt income, was 15 to 22 percent over the period 1962 to 1982.

Senator BENTSEN. Fifteen to twenty-two percent.

Mr. NUTTER. That's correct.

Senator BENTSEN. Now give me the parameters of how you identified that again. I want to be sure.

Mr. **Nutter**. Obviously, that would include taxes paid, but it would also include consideration for the lost income that the industry bears by its heavy investment in tax-exempt obligations. In other words, it takes into consideration the tax implications of the industry's investment in tax-exempt municipal and State obligations.

Senator **Bentsen**. You have so many numbers thrown at us here that I find it's important that we know what they base those numbers on because we can come up with very different answers.

Now when we get to this question of discounting, those people that are promoting discounting say that the issue is simply that if you don't have to pay the claim until sometime in the future, you can invest those premiums and earn interest until the claim is paid. And then they make the argument that if we impose discounting on property and casualty reserves, those that are arguing against it say the premium prices will have to go up.

Now how do you respond to the argument of the Treasury that discounting is a more correct tax treatment; that customers would be paying the real cost of insurance; not some lower cost that is subsidized by an incorrect tax treatment?

Mr. **Nutter**. Mr. Bentsen, if you are addressing that to me, the treatment of property/casualty reserves reflects a conservative accounting philosophy built into the regulatory system for insurance companies. It is a liquidating philosophy, if you will. The reserves are set up to pay, as Mr. Mitchell said, known claims. It is done in order to protect the policyholder and ensure that the funds are set aside for that purpose. There is no question that the industry invests the reserves to earn investment income during that period, but it's also true that the value of claims will increase overtime after that claim is filed.

Senator **Bentsen**. Well, some of the problems we have seen in the last year or two in financial institutions give me a great deal of concern. And as was stated a little earlier, just trying to extrapolate the last few years and conclude that's the trend for the future sometimes doesn't give you the kind of cushion that's necessary in meeting real disasters in the country. So I have a sympathy for trying to err on the side of conservatism when it comes to securing the financial stability of an institution.

Mr. **Nutter**. Mr. Bentsen, if I could add to my comment. One of the things the property/casualty industry has seen is a dramatic evolution of theories of liability to which its policyholders, municipalities and businesses and individuals are subject. The reason the industry has had a deficiency in its reserves over this time is its inability to assess the emerging, rapidly emerging, tort law. We would strongly discourage discounting, which we think would make it even more difficult to properly assess the company's true financial position.

Senator **Bentsen**. Thank you.

The **Chairman**. Senator Matsunaga.

Senator **Matsunaga**. Thank you, Mr. Chairman.

I can understand your deep concern. I was wondering why the White House is so bent upon destroying an industry which should be encouraged in every possible way. Did the industry, by chance, refuse to insure the California White House property? [Laughter.]

Or insure the risk of horseback riding? [Laughter.]

What do you suppose they have in mind when they make proposals such as you oppose?

Mr. OSBORNE. I think sometimes we've met the enemy and it's us. But I think in the time that I've spent up here, Senator, talking to staff, interfacing with Congress, one job that we really have to do as an industry is education. I would have to say we are probably the least understood of all major U.S. industries. And I think that's a challenge. And I think that people look on us with a deep-pocket theory that we've got all the money in the world, and we've got all the big buildings. And that philosophy, and that philosophy of deep pocket is simply not true because hopefully it will turn around. If it doesn't, for many of us time is running out. And it's a very interesting time to be in the business.

Senator MATSUNAGA. As I recall, in 1984 we provided for a 3-year study of the insurance industry. It's only 1 year since. I think there is so much misunderstanding of the insurance industry. I say this as an insurance agent of many, many years ago.

On the QRA, Mr. Mitchell, you testified that in your view it would tax property and casualty companies on amounts substantially in excess of their economic income. Now as you know or you should know, the Ways and Means Committee has come up with an amended proposal. I'm not sure as to the particulars, but would you care to comment on the Ways and Means proposal?

Mr. MITCHELL. Certainly. The Ways and Means options are somewhat like taking the worst of all worlds. They have selected one from each column on the agenda. The QRA by another name known as "cash basis method of taxation" will start January 1, 1989. Tax-exempt interest on non-GAO bonds would become taxable to the extent of 15 percent, as well as dividend-received credit on stock equities. There will be a limit in a property/casualty company using its net operating loss. There will be a limit on consolidation with a parent company. And, finally, the part of what the industry has proposed, they have thrown that in also, as I guess we are giving you that plus.

Senator MATSUNAGA. The question is: Do you oppose the options as proposed by Ways and Means as much as you do the President's proposal?

Mr. MITCHELL. After careful study, even more.

Senator MATSUNAGA. Even more.

Mr. Nutter.

Mr. NUTTER. We also oppose the House Ways and Means Committee staff proposals.

Senator MATSUNAGA. Mr. Osborne.

Mr. OSBORNE. Yes, we oppose them.

Senator MATSUNAGA. I see.

Senator LONG. I want to ask a question, Mr. Chairman.

The CHAIRMAN. Sure.

Senator LONG. I was here when we passed the 1959 law—that was under President Eisenhower. We passed a law which lasted a long time. It lasted for 22 years. In 1982, TEFRA came along. The Govermment needed money because it was running a huge deficit. Senator Dole did a courageous thing as chairman of this committee in meeting the charge to get some money back. We had cut taxes more than we could afford. At that time, it was proposed to raise taxes on the insurance industry. The industry cooperated, partly because it was suggested that if they did not cooperate, they were likely to get hit even worse later.

A couple of years later we were still running a huge deficit and another effort was made to raise money. We came up this deficit reduction package. As I understand it, this item was considered at that time and rejected.

But, again, the industry cooperated. The argument was that you ought to cooperate because otherwise you might get something worse next year. This is the third time and, if this thing should pass, you will have had four different laws to work under—the 1959 law, the 1982 law, the 1984 law and then the 1986 law. Each one is worse than the one before. Is that correct?

Mr. NUTTER. Mr. Long, much of what you have mentioned dealt primarily with the life insurance industry. The property/casualty industry did have some changes in those laws. But there is no question that being revisited every year or 2 years for any industry makes planning almost impossible.

Mr. MITCHELL. Senator, I would say, however, that your scenario is appropriate at this time since through the House Ways and Means Committee staff, despite the fact that the industry does believe it is paying its fair share of taxes, the fact that revenue has not flooded into the Treasury is due to the fact that it has had 4 or 5 years of exceptional losses. However, despite the fact that we feel we are paying our equitable share, we have been told in essence that if you do not like Treasury's poison then you should probably name your poison. As a result, the industry, all five trade associations, have agreed on an alternative to Treasury proposal, which would raise the same amount of revenue over the next 5 years as Treasury's proposal would raise. It is also a matter of reform of the Tax Code in that it answers a matching of agent or acquisition cost, agent commission or acquisition cost, with premium income. At the present time, statutory accounting of insurance companies requires premiums to be taken into income as they are earned. That being because if a policy is canceled, you must give the money back. So it's a liability.

This alternative proposal that the industry is putting forward to Ways and Means would say that 20 percent of the unearned premium would be taken into taxable income. That would match the acquisition cost or expense that is being taken. This would be a reform, a substantial reform, from the present method of tax accounting with respect to property/casualty companies, and would produce the same amount of revenue.

Senator LONG. Thank you.

The CHAIRMAN. Mr. Osborne, sometimes it helps to get things in perspective when you can use specific examples. Let's take your company. How big is it?

Mr. OSBORNE. Our company, Mr. Chairman, writes about $60 million. It has approximately $60 million in assets. And we operate in the four Western States.

The CHAIRMAN. And how many employees do you have?

Mr. OSBORNE. We have about 350 employees, sir.

The CHAIRMAN. So you are very typical of a small mutual property and casualty company?

Mr. OSBORNE. That's correct.

The CHAIRMAN. Now with a company that small, you mentioned in your testimony about the problem of extraordinary losses. What do you do to cover those? Do you lay most of them off ahead of time, reinsure them ahead of time, on the better safe than sorry theory, or what?

Mr. OSBORNE. Well, if you will recall the October 12, 1962 windstorm which you are familiar with, those losses were covered under catastrophe cover. So we, in effect, as an industry and as primary company, go out and buy catastrophe coverage to cover our exposures in the case of those extraordinary events, when they should occur.

The CHAIRMAN. You buy it before. I assume that generally you can't buy it afterwards.

Mr. OSBORNE. Oh, yes, we buy it before. And, yes, they buy it before. And it might be of interest that catastrophes, wherever they occur, will also have some effect in the rate we pay in the Pacific Northwest.

The CHAIRMAN. Because everybody else is laying it off and you are all being charged part of a catastrophic premium.

Mr. OSBORNE. That's correct.

The CHAIRMAN. If you all do that, then why are catastrophes particularly harmful to your company or any other company so situated if you have reinsured it elsewhere?

Mr. OSBORNE. Well, I think the answer is we could probably sustain a windstorm damage, depending on the severity. I can't imagine at this time any one worse than the one we experienced. The one we probably fear in the West more than anything is the earthquake. And it was commented on earlier. You move that Mexican earthquake up North and it would be very, very serious to many, many companies.

The CHAIRMAN. When you say you "lay it off," do you lay off everything over a certain amount, and, therefore, whatever the catastrophe is, you are going to pay the first $1 million or $5 million and the reinsurer is going to pay the other?

Mr. OSBORNE. When we write a homeowner policy, we will keep approximately $100,000 of it. If it's a $300,000 home, we lay off the additional $200,000 to a reinsurer.

The CHAIRMAN. Now do you do that policy-by-policy?

Mr. OSBORNE. Yes.

The CHAIRMAN. You do. OK.

Mr. OSBORNE. Well, it's done under treaty. In other words, it covers all classes of business within the classification, yes.

We used to lay them off individually, Mr. Chairman, but we do it overall by treaty now.

The CHAIRMAN. All right.

Now let me ask all three of you this question. Would it be possible to provide a rule that would limit the amount of tax-exempt interest that the property/casualty companies can obtain so that at least the profitable companies pay some money? Because you know what we are up against. We are forever being faced with the argument about companies that make money and pay no income taxes.

And if there is anything that the public thinks of when they think tax reform, it is individuals and companies that make great salaries or have great incomes and they pay no taxes. Is there anything that could be drafted that in your judgment would be acceptable and fair?

I will start with you Jim.

Mr. OSBORNE. When we look at the tax-exempt situation, I think probably as an industry we have more of the municipal bonds than probably any other. I think back 6 months ago, about 28 percent held by the GNP. That was a provision by Congress. And as an industry, we are not doing anything different than any other industry when they take in that income.

What we are saying at that point is that is sheltered income. And I would have serious reservations about using any of those moneys to create additional income.

Let me come back real quick to another point. We do put money back into the system. For example, last year the companies paid to the States $4 billion of premium tax which in our home State, sir, represents about the fourth largest source of income. So we take that and we shelter it like everybody else. But when it comes back the other way, I think we do our share.

The CHAIRMAN. But as far as you are concerned on the tax exempts right now, you don't see any way we could structure the law that would somehow—I'm not sure how—require taxes of at least profitable companies on that issue.

Mr. NUTTER. Mr. Chairman, if I could comment on that. The industry addressed that question in the context of the House Ways and Means Committee hearings and discussions with staff and members there. And the concern was that you single out one segment of the property/casualty industry for tax vis-a-vis others that would not be taxed. Therefore, we developed a proposal that Mr. Mitchell referred to to address the concern that we recognize the Congress has about the need to raise revenue in the context of this reform package. And what we have put forward does, in fact, meet the revenue target that was set in the President's tax reform package, and does not detrimentally affect one segment of the industry over another segment of the industry.

The CHAIRMAN. All right, now, Mr. Mitchell, tell me again how it does that.

Mr. MITCHELL. It will take into taxable income 20 percent of the unearned premium of any policy as it is written, usually done, of course, at the end of the year when you compile your records.

The CHAIRMAN. Say that again.

Mr. MITCHELL. Twenty percent.

The CHAIRMAN. Say the whole sentence again.

Mr. MITCHELL. It will take into taxable income 20 percent of the unearned premium of a policy. At the present time under the present tax law, which follows statutory accounting, only the amount of the premium on a policy that is earned is considered to be taxable income. The amount that is unearned, that is, for the term that has not yet occurred, is not taxable. For example if a policy is written for 12 months on July 1 and will expire until June 30th of the following year. In that calendar year, only 6 months of that premium has been earned, because only 6 months has expired.

This will take into taxable income, 20 percent of the unearned amount.

The CHAIRMAN. Unearned premium.

Mr. MITCHELL. Which equates to what the average acquisition cost is 20 percent for the industry. The industry has been criticized that it takes as expenses its acquisition costs, which it pays up front, but does not match it with all of the income coming from the policy. And this will answer that criticism. It was obviously a reform to the present tax law. And it will produce the tax dollars revenue, additional revenue, that is estimated to be produced by QRA and the other proposals of the administration. The industry supports that in a united way.

The CHAIRMAN. Thank you.

Senator Chafee.

Senator CHAFEE. Mr. Mitchell, the suggestion that you were talking about, the 20 percent, on the unearned premium, now somebody suggested that that will produce *x* dollars of revenue in the first 5 or 6 years, but then it tapers off quite rapidly. Is that accurate?

Mr. MITCHELL. That's correct, Senator. In the first 5 years, 1986 to 1989, assuming those are the years, due to a transitional rule, that is at the present time the unearned—well, as of December 31 of 1983, the unearned premium reserve of the insurance industry—and I have that figure here—is some $41 billion. This has not been touched. That's unearned premium. So it was further proposed by the industry that this—rather than taking 20 percent of $41 billion in 1986, that it would seem appropriate to do this in a transitional period of a period of 5 years. And take 4 percent, in essence, per year for 5 years, which would equate to 20 percent at the end of the 5 years. At the end of the 5 years, having already consumed into taxable income, all of the previous unearned premium, then 20 percent of the incremental addition would be taken into taxable income each year.

Yes, that would then be depended upon the growth of the industry 5 years hence on an annual basis. It, however, is projected to produce from 1991 to 1995 at an 8-percent growth factor $2.2 billion, and at a 10-percent compound growth factor, $3.2 billion.

Senator CHAFEE. Let me ask Mr. Nutter a question. In response to I guess Senator Bentsen and Senator Long's question about the tax rate, you felt that the companies were paying, didn't you say, 15 to 20 percent?

Mr. NUTTER. Over a 20-year period, 1962 to 1982.

Senator CHAFEE. But what do you say about the chart that Mr. Anderson has and which he refers to on page 3:

> We show on Table 1 that while property and casualty companies had about $46 billion in underwriting losses from 1975 to 1984, they had $121 billion in investment gains during this period, resulting in a net gain of about $75 billion for those years. For those years; namely, 1975 through 1984, federal income taxes were a negative $125 million, a rate of minus 0.02 percent of the net gain.

What are we to think of that?

Mr. NUTTER. Well, obviously, the industry's tax picture reflects other public policies. One public policy is the encouragement by the Tax Code, not just for this industry, but all industries, of investment in tax-exempt obligations. And, therefore, the revenue earned by the industry comes heavily from tax-exempt obligations.

Senator CHAFEE. Now did Mr. Osborne say that was about—what did he say? About 27 percent of the portfolio?

Mr. OSBORNE. Somewhere in that area, Senator.

Senator CHAFEE. All right. Let's say it's 30 percent. You were talking not your company, but the companies that belong to your association, Mr. Osborne, when you said that?

Mr. OSBORNE. What was the question, sir?

Senator CHAFEE. When you said the 27 percent, that wasn't for your company?

Mr. OSBORNE. No; that was the figure I had back a year or so ago of around 28.

Senator CHAFEE. Well, make it 30 percent. Nonetheless, that leaves 70 percent that presumably is taxable income from investments. And when we see that there is a minus 0.02 percent of the net gain of $121 billion—a net gain, excuse me, of $75 billion, don't you think we are tempted to do something?

Mr. NUTTER. I don't have the chart or the figures in front of me, Senator, but certainly the taxes paid from the industry reflect the breadth of the industry. Much of that tax fell heavily on those companies which were profitable. And the taxes were paid. A strong percentage of the industry has not paid taxes primarily because the code is currently written on the concept that the companies would pay on the basis of economic gain. And my recollection is that only 2 of the last 10 years has the industry had an underwriting profit.

Mr. MITCHELL. I believe also, Senator, that the GAO in their charts are using information from Best. The IRS, I believe, has a higher effective tax rate for the industry than does Best. As Mr. Nutter also indicated, the reason that the industry has had a negative tax payment, a negative effective tax rate, is the horrendous losses that the industry has had in the previous 3 or 4 years.

Senator CHAFEE. Underwriting losses.

Mr. MITCHELL. Underwriting losses that have more than offset its entire investment income. It had a net operating loss—count everything you will—in 1984. Tax exempts, et cetera.

Senator CHAFEE. Yes; I know in 1984, but he took the period of 10 years from 1975 to 1984.

Well, thank you, Mr. Chairman. My time is up.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. I want to thank all the gentlemen.

The CHAIRMAN. Gentlemen, I have no other questions. Thank you very much.

Mr. OSBORNE. Thank you very much.

Mr. MITCHELL. Thank you.

Mr. NUTTER. Thank you.

The CHAIRMAN. Next can we have Fred Deering, Edward Phillips, Harry Phillips III, Alan Press, and Wayman Cox.

Gentlemen, do you have any objection to going in the order that you are on the witness list?

[No response.]

The CHAIRMAN. If not, we will go with Mr. Deering, a man whom I have met on a number of occasions, but whose brother I have known also for a quarter of a century, who is a very successful practicing lawyer in Portland.

Senator LONG. Mr. Chairman, could I ask that Mr. Cox appear first because I will have to leave shortly.

The CHAIRMAN. Mr. Cox, so long as you are an outstanding citizen of Louisiana, you may go first.

STATEMENT OF WEYMAN H. "SKIP" COX II, CHARTERED LIFE UNDERWRITER AND CERTIFIED FINANCIAL PLANNER, SHREVEPORT, LA

Mr. Cox. Thank you.

Just last year, the Congress, including this committee, completed the gargantuan task of reforming the taxation of life insurance companies and their products. To reopen life insurance taxation again within months of the completion of this monumental achievement is the equivalent of rewriting the entire Internal Revenue Code in 1985 and opening it all up to do it again in 1986.

One of the coauthors of last year's life insurance taxation reform bill, Congressman Henson Moore of Louisiana, when asked what should be done this year about reforming life insurance taxation, said "If it ain't broke, don't fix it! We fixed it last year."

The other coauthor of the bill, Representative F.H. "Pete" Stark, stated this year in hearings before the Ways and Means Committee to Secretary of the Treasury Baker, "It would be unfair to reopen life insurance taxation again."

So why are we here? We are here because the same group that brought us public outrage over the bank withholding and automobile expense contemporaneous record laws--now repealed—attached their oft-defeated prejudices attacking life insurance to the President's tax reform proposal and launched them as an unguided missile from the bowels of the Treasury Department. Asking the Treasury Department to come up with a recommendation of what proper taxation should be is equivalent to asking Dracula to come up with a defense plan for the blood bank. [Laughter.]

Mr. Cox. My name is Skip Cox, and I'm a chartered life underwriter and a certified financial planner. In the interest of the millions of American individual life insurance policyowners, which include my clients, I appreciate and thank the committee for the honor and the privilege to testify.

These new proposals that create a brand new tax on the unrealized cashless appreciation of a life insurance policy, that policyholders have never received, actually received, constructively received, and if they die, will never receive, doesn't make any sense. Assistant Secretary of the Treasury Department, Ronald Pearlman says that life insurance is the greatest tax advantage in the financial services industry. What is the tax advantage of paying a nondeductible premium from after-tax net spendable income, which, if surrendered during the lifetime of the policyowner, creates either (1) fully taxable ordinary income or (2) a nondeductible loss?

The current Rostenkowski/staff option proposals introduced before the House Ways and Means Committee are also unfair because they taint the brilliant product of life insurance which has enjoyed 200 years of unparalleled financial success, by tainting it with the financial malignancy of taxing the proceeds of policy loans. Even though never recommended by the President and defeated by this committee just last year, guess what has miraculously appeared in the markup work papers of the Ways and Means Committee? A provision to treat policy loan proceeds as taxable income, and policy loan interest as nondeductible insurance premiums.

Countless opportunities have been taken advantage of and problems averted by American policyowners through the loan values of their life insurance. Disneyland was finished because Walt Disney, in a moment of financial peril, was able to borrow against his life insurance. An agent friend of mine died and his widow received $85,000 of death proceeds because of the automatic premium loans that kept the policy in force while he was in the hospital and noone paid the premiums.

It's not fair to treat life insurance loans and interest paid on life insurance policies any different than any other loan or any other interest. The purpose of the President's program is to create what is simple and fair.

Marketing life insurance in the last 4 years with these repetitive taxation changes, threats, and the tax sword of Damocles hanging over our head, has been equivalent to selling subdivision lots in the midst of an earthquake. [Laughter.]

Nobody can make a long-term financial decision under continued tax change bombardment! The latest "Taxquake" is the Ways and Means Committee with their proposed effective September 25th date which put 400,000 licensed life insurance agents out of business and put in limbo needed decisions involving life insurance purchases for millions of Americans til you in Congress completely reject overhauling the Tax Code which will probably take 6 months to 1 year.

The individual States premium taxes of $1½ billion will be eroded. In addition, the 1990 $200 million of revenue will never happen. Nobody will buy living cash value life insurance with these onerous new taxes on the policyowners.

In May of 1985, Representative Breaux of Louisiana stated that 165 of the Nation's largest corporations paid no income tax. Among those were General Electric with $6.5 billion of income. GE not only didn't pay any tax; they got a $293 million refund. Taking the time and energy of the Congress and this committee to approach and try to raise negligible or de minimis sources of revenue by taxing the millions of individual life insurance policyowners while these gargantuan alternative sources of revenue are available and we as a nation are hemorrhaging over $200 billion in budget deficits, is equivalent to having the National Guard called out to collect parking meter fines while murderers, rapists, and felons run wild in the streets! It ain't broke; don't fix it! You fixed it last year!

Thank you.

The CHAIRMAN. Thank you. Mr. Deering, do you want to follow that?

Mr. DEERING. It's a hard act to follow. [Laughter.]

[The prepared written statement of Mr. Cox follows:]

STATEMENT
OF
W. H. "SKIP" COX, II, CLU, CFP
BEFORE
THE UNITED STATES SENATE
COMMITTEE ON FINANCE
ON INDIVIDUAL LIFE INSURANCE POLICYOWNER TAXATION OF THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY

OCTOBER 1, 1985

I.

INTRODUCTION

Just last year, Congress through the conscientious and positive efforts of the members of this Committee, including the finest statesman Louisiana has ever produced, my Senator, Russell B. Long; Senator Robert Packwood, the Chairman of this Committee, and Senators Bentsen, Boren and Pryor, completed the gargantuan task of completely reforming the taxation of life insurance companies and their products, to the admiration and satisfaction of millions of American life insurance policyholders, insurance agents, companies and trade organizations.

To reopen taxation of life insurance again within months of the completion of the monumental achievement is the fractional equivalent of rewriting the entire Internal Revenue Code in 1985, and reopening hearings to do it over again in 1986.

On May 18, 1985 Congressman W. Henson Moore said, "If it ain't broke, don't fix it. It has been fixed. We just fixed it last year."

Congressman Fortney "Pete" Stark, the other co-author of the legislation, stated to the Secretary of the Treasury Baker in hearings before the House Ways and Means Committee earlier this year, "Last year's deficit reduction act completely overhauled the tax treatment of life insurance companies and their products. It would therefore be unfair to reopen life insurance issues again this year."

As stated by Donald C. Alexander, former Commissioner of the Internal Revenue Service, before the House Committee on Ways and Means on June 5, 1985, "While annual model changes may be needed in the automobile industry, they serve no purpose in the tax system."

In the interest of millions of American individual life insurance policyowners, and on behalf of my clients in particular, I appreciate the opportunity to comment with respect to certain aspects of the President's proposals for reforming the tax system.

I, along with the vast majority of Americans support the President's objectives of fairness, growth and simplicity of the tax system. However, the provisions that change again the taxation of life insurance companies and their products and create a new tax to be paid by millions of individual life insurance policyowners are neither fair, growth productive, nor simple.

II.

FAIRNESS

A. THE PROPOSALS ARE UNFAIR TO MILLIONS OF AMERICAN INDIVIDUAL LIFE INSURANCE POLICYOWNERS AND THEIR BENEFICIARIES

1. A BRAND NEW TAX ON THE "CASHLESS" UNREALIZED APPRECIATION OF LIVING CASH VALUE LIFE INSURANCE POLICIES

The proposals are unfair because they would tax the unrealized appreciation in the living cash surrender value of a life insurance policy (inside build-up) as current taxable income to the policyowner despite the fact that the policyowner has not received any money.

As reported by the Wall Street Journal in an article on June 17, 1985, a 35-year-old father purchasing a $40,000 typical whole life policy for $535 a year, would start paying additional taxes at age 37, when he would be taxed on additional income of $98. That additional taxable income would go to $584 a year at age 45; to $1,318 at age 55; $2,123 at age 65; and $2,898 at age 74, when he would reach his life expectancy. The policyowner in this example will be taxed on thousands of dollars of income, and not receive a penny in cash.

Taxing policyowners on the unrealized appreciation in the value of their policies is equivalent to taxing homeowners on the unrealized appreciation in their home. Even under current law, life insurance policyowners get a harsher taxation than homeowners. When a homeowner sells his home, the profit is the capital gain at worst, and at best there is no tax because of rolling the proceeds into the purchase price of a new home within a year or, the over age 55 lifetime exemption. The life insurance policyowner, on the other hand, has to pay ordinary income tax on any profit from the surrender of his policy and any loss is nondeductible.

2. LIFE INSURANCE PREMIUMS ARE A NON-DEDUCTIBLE EXPENSE PAID FROM THE POLICYOWNER'S AFTER-TAX INCOME.

The proposals are not fair because they would require that policyowners would have to pay a tax in addition to non-deductible premiums in order to protect their families. Logically, who would do it? You're right. Nobody! Can you imagine trying to explain to the 35-year-old father the "fairness" of why his paying a non-deductible premium of $535 a year for his $40,000 policy creates $584 of additional taxable income by the time he's 45, and that it will get larger every year?

The logic of this tax theory may seem crystal clear to the tax collector, but never to a taxpayer, nor will it produce in the minds of taxpayers an unbridled enthusiasm or an impression of "fairness" for the President's overall program.

Recently, I made an insurance sales presentation to one of my policyowners, a Cajun, down in Southwest Louisiana. When I explained to him that if the law was changed, he was going to have to pay income tax in addition to him premiums he said, "Mon cher (my friend), I bet dat de fella dat thought dis up is the same one dat wrecked my truck." I asked him to explain. He said, "My tax man, he come to see me and he bring a book wid him and he tell me dat I got to write down everywhere I go, how far it is, who I see, what about, what time, what day, or de IRS would come and git me. I was drivin' my truck down by Bayou La Fourche (La Foosche) and I was writin' down all dat stuff for de IRS in dat book as I drove along. When I looked up, I done run out of road and me and my truck went into the Bayou. I bet dat fella in Washington dat thought up dat book and wrecked my truck is the same one that thought up this 'fonchock', (crazy) insurance tax deal."

My policyowner also commented later that he had been extremely relieved to have learned from his tax man that the IRS had changed their mind and didn't need his book any more because, as he said, "De alligators got dat book."

3. IT IS UNFAIR TO TAX POLICYOWNERS ON CASH VALUES THEY HAVE NOT ACTUALLY RECEIVED, OR CONSTRUCTIVELY RECEIVED, AND MAY NEVER RECEIVE.

Individuals are normally taxed on "Actual Receipt" of income, such as wages, bonuses and dividend checks, and income for which they are in "Constructive Receipt". Interest automatically added to savings accounts, money market funds, and reinvested dividends from mutual funds are examples of proper taxation due to constructive receipt.

The tax theory is, that since the taxpayer has the choice of either taking the income in cash or having it automatically reinvested, he has constructively received the income and properly, should be taxed. This is certainly not true of the unrealized appreciation of a life insurance policy. The living cash surrender value of a life insurance policy can only be "actually received" in one of two events. First, the policyowner, during the insured's lifetime, can surrender the policy back to the issuing insurance company and in return receive a check for the policy's cash surrender value. Secondly, at the death of the insured, the policy beneficiary will receive a check equal to the death proceeds of the policy. Where did the living cash surrender value go? It disappeared when the insured died. What did the deceased policyowner get? A lifetime of non-deductible premium expense from his after-tax income and not another red cent.

Prior to the death of the insured or the cash surrender of the policy, the policyowner can borrow from the insurance company and pledge the policy as collateral, but that loan requires that 1) annual interest be paid and that 2) the principal be repaid. There is no escape from either the payment of interest or repayment of principal. If the policyowner refuses to pay the interest directly, the interest is added to the principal of the outstanding policy loan. At the point in time when the amount of the policy loan plus the accrued interest exceeds the cash surrender value of the policy, the policy automatically self destructs, is cancelled and creates a taxable event. Why? The policyowner irrevocably disposed of his property (the policy) in return for the cash surrender value which, under the terms of the collateral assignment to the insurance company, was used to repay the legal debt of the policyowner, the outstanding policy loan plus accrued interest. It's the same as if the policyowner had borrowed money from his bank; pledged the policy as collateral; defaulted on his note, and the bank as the creditor collateral assignee had cash surrendered the policy and used the proceeds to repay the policyowner's debt.

The policyowner will report ordinary taxable income equal to the gain, if any, of the difference between the cash surrender proceeds received and the net premiums paid. In the event that the cash surrender proceeds of the policy are less than the net premiums paid, there is no corresponding ordinary or capital tax deductible loss.

If there is an outstanding policy loan at the time of the insured's death, that loan plus any accrued interest is repaid from the death proceeds and the remaining balance of the proceeds are paid to the policy beneficiary.

The point is, that neither the policyowner nor the beneficiary is ever in "constructive receipt" of the value of the policy, and is only in "actual receipt" of any proceeds either by 1) surrender of the policy during the insured's lifetime or 2) death of the insured.

4. THE PROPOSALS ARE UNFAIR BECAUSE THEY IMPUTE TO THE POLICYOWNER ANNUALLY INCREASING "PHANTOM" TAXABLE INCOME EQUAL TO ONE-YEAR RENEWABLE TERM INSURANCE PREMIUMS.

Imputing "cashless" income to a policyowner equal to the annual premium that would be charged for a like amount of one year renewable term insurance is equivalent to imputing taxable income to a homeowner equivalent to the annual rent the homeowner would otherwise pay.

In addition to income actually received or constructively received, taxpayers are taxed on in kind compensation for which they receive the "Economic Benefit". An example would be free rent provided by an employer to an employee. It is unfair and inaccurate to try to apply this theory to life insurance.

The Economic Benefit doctrine of taxation is properly applicable for in kind benefits received either as compensation between employer and employee or as proceeds from sale or disposition of property between contracting or selling parties, etc., but not from the ownership of one's own property. No American has ever had to pay tax on imputed income equal to the "use" value of a chair, house, automobile, suit, boat, or any other property that the taxpayer owns. Congress has historically recognized that the private ownership of property is the foundation of a free society; the driving force in a free economy and the "use value" of that property is not taxable income.

5. THE PROPOSALS ARE UNFAIR BECAUSE THEY "FINANCIALLY DISFIGURE" LIFE INSURANCE BY LIMITING THE DEDUCTIBILITY OF POLICY LOAN AND OTHER CONSUMER LOAN INTEREST.

If the proposals pass, they will set a new precedent of the non-deductibility of consumer loan interest. It will only be a matter time before the $5,000 limit, or whatever limit finally passes, will be removed by future legislation. The goal of the tax theorist is to not allow the deduction of any interest. The only reason that the proposals allow deductibility of $5,000 of consumer loan interest and interest paid on the primary residence is to avoid arousing insurmountable public opposition to the overall program. Once the camel gets his head under the tent, it will only be a matter of time before they will be back to get the bait they left in the trap.

Interest paid on loans of any type, including homes, automobiles, insurance, etc. should be a deduction from taxable income. If the only interest deductible from taxable income is that paid on an individual's primary residence, Americans will never own their homes! Individuals will always need to borrow money for all the well-known various reasons throughout their lifetime. If the interest on primary residence loans are tax deductible and the interest on all other loans is not, on what asset do you think Americans will borrow money? Encouragement of individual home and life insurance ownership has long been recognized as good social policy. The proposals are unfair because they discourage home and life insurance ownership.

People hate to make the long-term capital commitment involved in purchasing permanent whole life insurance protection, unless they know they will have clear, unrestricted access to their living cash surrender values by borrowing, should it become necessary.

It's no secret to any of us here that the Treasury Department has for years attempted to have legislation enacted that would deny or severely limit the deductibility of interest paid on policy loans and/or treat policy loan proceeds as taxable distributions. Their purpose was not to raise additional revenue (which by their own calculations is too small to measure), but to put into law their concept of "proper tax policy." Congress has just as consistently rejected these proposals. Thank God for representative government!

The loan value of life insurance creates many benefits, which might not, at first glance, be apparent. It keeps life insurance in force if the premium is not or cannot be paid. Life insurance normally has a thirty-day grace period during which the coverage stays in force even if the premium is not paid when due. With a term insurance policy, if that premium is not paid within thirty days of its due date the policy lapses and there is no insurance in force. Not only is the term policy not in force should the insured die, but the insured must provide evidence of good health in order to get his policy back. During the course of a lifetime, the premium on a policy may not be paid for any number of reasons. The premium notices may be lost or delayed. The policyowner may forget, move, get sick, be in an accident, become mentally incompetent, run short of funds, go bankrupt, go on vacation, get married, get divorced, or any number of other events. With policies having living cash surrender/loan values, the protection stays in force indefinitely, for years, either through automatic premium loan or automatic extended term insurance. Every life insurance policy that has ever been in force on the life of a deceased insured should be verified with the issuing company as to whether any benefits are payable no matter how long it has been since any premiums were paid. It is not uncommon for a policy to silently remain in force for five, ten or fifteen years following cessation of payment of premiums completely unknown to either the policyowner or the beneficiary.

I began my insurance career with the Prudential Insurance Company on a debit in 1961. We had a very sophisticated operation. We had one telephone, two staff managers, ten agents, no secretaries, no computers, no typewriters or calculators. The only thing we had was a deep and motivating desire to avoid a sustained case of the "missed meal cramps." One of the agents I worked with was named Wes. Wes was in his early thirties, married, two children, and had a crew cut as flat as a table top and the ugliest blue Nash I had ever seen. One day Wes and I were in the office enjoying a temporary escape from the continued and unrelenting rejection we suffered at the hands of our prospective life insurance purchasers. Wes got up to get a drink of water, and on his way to the fountain suddenly stopped, grimaced in pain, and fell to the floor. We rushed him to the emergency room of the hospital, where he was admitted with a "possible heart attack." After a few days in the hospital, Wes was sitting up in bed, feeling fine, and doubting that he had had a heart attack after all. A staff manager, Jim Cash, was visiting Wes in his hospital room, when all of the sudden, Wes suddenly sat up in bed wide-eyed, threw out his arms, knocked over a lamp, and screamed, "Oh, my God, No!" and died.

Following Wes' funeral, in which I was a pallbearer, we were going through his desk drawer and found two life insurance policies for over $85,000. Upon checking with the company, we found out that the premiums on these policies had not been paid, but because of the automatic premium loan resultant from the living cash surrender/loan value of the policy, the coverage was in full force and effect. Wes' wife and children had $85,000 instead of nothing. Why? Because the policies Wes had purchased were permanent, whole life policies with living cash surrender/loan values. Had Wes purchased term insurance instead of whole life, his family would have been left destitute. Millions of dollars in death claims have been paid to beneficiaries under similar circumstances because of the lapse-proof feature of living cash value life insurance. This would never have resulted from term.

Countless opportunities have been taken advantage of and problems averted by American policyowners through the use of the loan values of their living cash value life insurance. Businesses have been started; medical bills paid; childbirth expenses paid; college tuition paid; bankruptcy averted; businesses saved; taxes paid; payrolls met; bank loans granted; SBA loans approved; homes purchased; plants built; inventory supplied; and all of life's other events that suddenly required the need for cash; now! The only place an American knows he can never be turned down for a loan, even if he is financial destitute, is from his insurance company with the living cash value of his life insurance policy pledged as collateral.

Representative Sam Gibbons (Florida) said, "I oppose taxing the accumulated cash value of an insurance policy; I am all for savings incentives and believe insurance has been a savings vehicle. I personally borrowed against my insurance when I had children in college. Congress examined life insurance taxation last year and enacted legislation substantially revising it, affecting companies and policyowners. We should give these new rules a chance to work."

Anything that puts a penalty on the ability of people to borrow on their life insurance policies damages the good the loan provisions create. With Americans, ownership of their home and life insurance form the bedrock foundation of their personal financial security. Interest on policy loans should be tax deductible and not subject to any limit, as long as any interest is tax deductible and not subject to a limit. It encourages the acquisition of permanent level premium cash value life insurance, with the resultant social good it produces for the individual family, businesses and the nation. The loss in tax revenue is minuscule.

This month America celebrated the thirtieth anniversary of the opening of Disneyland. A recent television program commemorated this event and the history of how Disneyland came to be and the life of Walt Disney. The bankers thought Walt Disney was crazy with his idea of a multi-million dollar amusement park. In order to raise the necessary nineteen (19) million dollars in financing, Walt and his brother pledged all their personal and business assets, including their stock in Disney productions, and "Walt even had to borrow money on his life insurance". Millions of our children have, and millions of unborn children will thrill to the genius of Walt Disney and the Disneyland and Disneyworld that he created. The policy loans that Walt Disney made on his life insurance not only enabled him to complete Disneyland but provided protection to his creditors, business and family in the event of his death during construction. Thousands of small businesses across this nation have been saved, started or grown because of the utilization of the loan values of permanent living cash value life insurance on the life of the business owner.

The Treasury Department stated in their 1983, 1984 and 1985 attempts to deny the tax deductibility of interest paid on policy loans, that it was not a revenue issue. The tax revenue that would be raised is so small they could not measure it. They wanted the deduction eliminated because they considered it to be "proper tax policy." How could life insurance, which has produced so much good, for so many, for so long remain under such continued attack? I wonder what Walt would say?

6. THE PROPOSALS ARE UNFAIR BECAUSE THE NEW TAX CREATED IS A "AGE INDEXED TAX" ON THE ELDERLY

One out of eight women in this nation are widows. Almost every married woman can be expected to survive her husband. The reasons for this are two-fold. First, women have a life expectancy of approximately five to seven years longer than males of the same age. Secondly, women tend to marry men somewhat older than they. The result is each married woman can expect a widowhood of approximately thirteen years.

Approximately 85% of all Americans will live past age 65. Let's look at our 35-year-old father after he has raised his children and is 65 years old. His $40,000 policy still has the same original level premium of $535 per year. The premium will be hard enough to pay from a reduced retirement income, but in addition to the premium, he will have to pay tax on $2,123 of additional income for that year. He will be further saddened and alarmed to find that the amount of taxable income will increase to $2,898 by age 74. He will be faced with a terrible dilemma. Either he must pay non-deductible premiums plus ever-increasing taxes from a limited retirement income, or cancel his insurance. This will leave his wife unprotected, the wife he has raised his children with and lived with for a lifetime, knowing she will only have Social Security to provide for her after he's gone. The shadows of life are lengthening and the inevitable is no longer in the distant future. This is "fair"? This is proper tax and social policy?

Cyril F. Brickfield, executive director of the 18,000,000 member American Association of Retired Persons (AARP) stated in a news release on April 12, 1985, "This proposal in the Treasury Department's tax plan would have its most dramatic impact on older Americans. Cash values on life insurance increase significantly in the years after retirement, so taxes would go up as a person grows older. Simply put, the older the individual, the greater the tax liability."

7. THE PROPOSALS ARE UNFAIR BECAUSE THE DOMINANT PRODUCT WILL BE TERM INSURANCE WITH OPPRESSIVE, UNBEARABLE INCREASING PREMIUMS FOR THE ELDERLY.

If the current proposals become law, no one in their right mind will buy a permanent living cash surrender value life insurance policy. The "Washington Tax Report" of the Certified Public Accounting Firm of

Seidman and Seidman stated, "Term life insurance will be your best bet if the proposal becomes law."

The cost for a $40,000 equivalent term policy for our male age 35 is as follows:

$40,000, Male, Age 35
Annual Renewable Term

	Annual Premium	Cumulative Premiums Paid
Age 35	$ 59	$ 159
Age 45	121	810
Age 55	278	2,549
Age 65	690	6,812
Age 75	1,999	18,278
Age 85	5,352	50,896
Age 95	11,494	128,326

Attempting to keep term life insurance in force for the elderly is like trying to ski up a ski jump.

In his statement of April 12, 1985, Mr. Brickfield of AARP also stated, "The life insurance changes proposed by the Treasury would limit the ability of older Americans to keep their essential life insurance protection, thus undermining the well-established social importance of life insurance protection. The Treasury proposal would interfere with financial self-sufficiency and would eventually result in even greater demands being placed upon the Social Security system and other social programs. The adverse impact this proposal would have on older Americans in terms of cost and financial security makes it bad social policy."

You can see why level premium life insurance evolved. It was in response to public outrage! The aged were incensed that they were forced to give up their life insurance because of the unbearably increasing premiums as they approached life expectancy. A method was devised where people could pay a level, non-increasing premium for the "whole" of their life until death. It was called "whole life". The way it worked was: Policyholders paid a level premium that was more than necessary while they were young in order to subsidize the insufficient level premium when they were older. The level premium whole-life policy was an immediate and continuing success and is now more popular with the American policyholder than ever before.

Another problem developed, when policyowners would discontinue their level premium policies while they were still young. Life insurance companies, then like today paragons of business equity and virtue, refused to refund any of the excess premiums that had been accumulated in the "reserve fund". The unused fund was designed to subsidize the inadequate level premiums as the insured's age advanced toward life expectancy. "Non-forfeiture value" legislation was passed by the individual states which required insurance companies to refund a minimum portion of the accumulated excess premium reserve fund upon cancellation of the policy as a "non-forfeitable cash surrender value" to the policyowner.

8. THE PROPOSALS ARE UNFAIR TO THE BENEFICIARIES OF LIFE INSURANCE, SUCH AS FUTURE WIDOWS AND ORPHANS BECAUSE THEY ASSURE THAT 90% OF THE INSURANCE POLICIES WILL NEVER RESULT IN A CLAIM.

The general consensus of financial opinion is, that if the proposals become law, term insurance will be the dominant product. Life insurance company records show that 90% of all term insurance policies issued are cancelled or lapse while the insured is still living. The reasons are the same old ones. The first time there is any living financial difficulty there is not reserve fund to pay premiums or borrow against. The ever-increasing cost is unpalatable. There is no living value created. The cost is unbearable at the advanced ages and the coverage is discontinued. Is it "fairness" and good social policy to pass legislation will be creative enough to figure out some way to buy assets on which the tax will be delayed, minimized or postponed indefinitely. Is it possible that raw land in the Canary Islands; owned by a trust domiciled on the Isle of Man; of which the trust grantor is a Bermudan subsidiary of the Infidelity Life Insurance Company could escape taxation on the unrealized appreciation of Columbian crop options? If so, variable life will be the only product that can be marketed in lieu of term insurance. Can you imagine several hundred thousand former traditional life insurance agents obtaining their security license through ten-day cram courses and being loosed, in mass, on the public to sell variable life with investment options including such things as diamonds, stamps, rutabaga futures, and Boone Pickin's takeover options? What a source of financial stability for widows and orphans and a producer of capital for the nation!

A NASD licensed securities representative can normally represent only one broker dealer. The newly-licensed agent will no longer be able to choose from among various insurance companies and various insurance products, the best policy for his policyholder. Agents will be forced to go to back to the early days of life insurance when the agent sold not what was best for the consumer, but what was best for mother insurance company.

B. THE PROPOSALS ARE NOT FAIR TO THE UNITED STATES CONGRESS, INCLUDING THE UNITED STATES SENATE AND THE MEMBERS OF THE COMMITTEE ON FINANCE

1. THE PROPOSALS ARE UNFAIR BECAUSE THEY ASK CONGRESS TO RELEGISLATE WHAT HAS JUST BEEN COMPLETED, THE 1984 CONGRESSIONAL TAXATION REFORM OF LIFE INSURANCE COMPANIES AND THEIR PRODUCTS.

The Treasury Department is like the fellow who bet ten dollars on the outcome of a football play and wanted to bet another twenty on the instant replay. The Congress spent over four years on life insurance taxation. Representative Moore, a co-author of the legislation, in an interview with the Wall Street Journal stated, "We've spent more time rewriting the taxation of life insurance than anything I've done since I've been in Congress. There is no reason to revisit it."

Representative Fortney Stark, a co-author of the legislation, stated to Secretary of the Treasury Baker in hearings before the House Committee on Ways and Means, "Last year's Deficit Reduction Act completely overhauled the tax treatment of life insurance companies and products. It would therefore be unfair," he said, "to reopen life insurance issues again this year."

My son, Cory, will be 13 the first of next month. He has unyielding convictions as to his future vocation. He says: "Dad, there's no reason for me to go to school. I'm going to be a rock star!" In addition, he repeatedly makes impassioned pleas for the acquisition and installation of a set of electrified drums (complete with massive amplifiers), as an indispensable, immediate requirement for his chosen life's work. He assures me that unless he gets these drums, his life will be permanently and irrevocably crushed and will lose all meaning. Several times, in a weak moment, he has succeeded in luring me into the establishments of the purveyors of these vital instruments; always with the same results. I experience extreme agitation, similar to that of a cat trapped in a microwave, along with "Richter scale" headaches and hyperventilation. Other than an exquisite instant relief upon leaving the establishments, I can recall no positive results associated with these "outings of togetherness." I have repeatedly expressed to Cory my feelings on the matter as a result of these past experiences. That is, "NO DRUMS!" Cory is undaunted as ever. He repeatedly, consistently and unrelentingly requests in all manner of ways and under all different types of circumstances, "Dad, please buy me some drums." Upon one of the more recent occasions of this event, I irritatingly asked Cory, "Son, why do you keep asking me to buy you drums when I've told you a hundred times, NO!" He looked up at me with a grin from ear to ear and his blue eyes sparkling and said, "Dad, all I need is one yes!"

The Treasury Department on life insurance with the Congress is like Cory with me on the drums. Congress has told the Department "No, No," and after almost two years of pleading last year, "No," again! Well, here they are again, and I'm afraid. Why? Because I really don't think Congress is going to pass a new tax on people's life insurance, and I don't think the Treasury Department thinks so either. But, I can sure see them exhuming the corpses of their oft repeated proposals buried again by Congress last year. I am afraid of them encouraging the Congress to reintroduce those proposals at some stage of the legislative process. I can hear them now, whispering at mark-up, "Let the insurance industry have tax-free inside build-up, but reduce the income tax basis of the policy by the 'Economic Benefit' value of the equivalent yearly renewable term premiums, as we proposed in 1983; and severely limit the tax deductibility of policy loans, as we proposed in 1983 and '84 and '85; and treat policy loans in excess of basis as taxable distributions, like we did to annuities in 1984. For 1985, let's propose a 'compromise' with the Congress and ask the insurance industry to give up the policyowner issues we lost last year in return for the tax-free unrealized appreciation of life insurance policy living cash surrender values."

If a small nation is repeatedly attacked by a larger, more powerful aggressor, and each time it compromises some of its territory to that aggressor, it has a tendency to reduce the geographic size of the country. Individual life insurance policyowners have been in the tax change barrel for three years. Enough is Enough!

The Great Lady of life insurance would suffer sudden death at the hands of a new tax on the unrealized appreciation of all policies; or the slow death of a new tax on the unrealized appreciation of new policies; or be permanently financially disfigured by the acid of non-deductibility of interest (current proposals); and/or taxing the proceeds of policy loans; and/or reduction in the income tax basis of the policy by the imputed equivalent yearly renewable term insurance premiums (previous Treasury proposals).

2. THE PROPOSALS ARE UNFAIR IN THE OPINION OF MANY MEMBERS OF THE CONGRESS OF THE UNITED STATES.

Many members of the House and the Senate, on both sides of the aisles, reflecting what they are hearing in great voice and volume from their constituents, have in turn made their own views known on the policyowner issues and the fact that Congress does not need to redo life insurance taxation. Here is just a sampling of what members of Congress have said:

Representative Barbara Kennelly (Connecticut) said she would be embarrassed to have to go back to her constituents and tell them that life insurance will be reexamined after years of Congressional study and last year's overhaul.

Senator Jeremiah Denton (Alabama), to Treasury Secretary Baker: "I am writing you to urge that Treasury amend its tax reform proposal to eliminate those provisions that would affect the taxation of life insurance companies and their policyholders. I believe that enacting those provisions would be both unfair and unwise.

Senator Alfonse D'Amato (New York): "The Treasury Department's tax reform plan has been presented to the White House for review. I expect many of the more onerous provisions of the reform package to be eliminated. I assure you that I will be watching carefully to see if the provisions impacting life insurance are removed."

Senator Paula Hawkins (Florida): " A provision that I find objectionable is the proposed taxation of the inside build-up in life insurance policies and annuities. This cash build-up makes adequate life insurance affordable throughout one's lifetime. Since cash values are not realized income, this provision would essentially be creating a tax on cash that is not received annually and would discourage taxpayers from purchasing permanent policies."

Representative Philip Crane (Illinois): "I do not feel that we should be taxing people on money they do not directly receive during the year. The increased taxation of insurance policies, and even the taxation of interest received from savings accounts, only discourages the savings and investment necessary to spur on economic growth."

Senator Don Nickles (Oklahoma): "Taxing the 'inside buildup' or increased cash value of a policy is not a reform of an existing tax; it is a brand new tax. The plan would base this new tax on a benefit not received and would be complex to report and administer. As a result, most policyholders would surrender the policy to pay or to avoid the tax. For life insurance policy loans, the Treasury proposed to tax those loans as distributions. These loans are simply that, a loan to the policyholder from his accrued benefit in the policy. He will repay that loan with interest or it will be deducted from the death benefit. If the Treasury proposal is in fact a modification of the present income tax, then loans of any kind should not be taxed. Another negative impact on policy loans is the proposal to limit the deductibility of nonmortgage interest. This would have the effect of reducing life insurance in force thereby eliminating needed capital to stimulate the economy."

Representative Howard Coble (North Carolina): "The original proposal from the Department of the Treasury calls for the taxation of the "inside buildup' of life insurance policies. The results of this would be catastropic. Not only would this destroy any incentive for savings within the insurance industry, but it would have a negative impact on the Treasury in the long run. This change would remove the incentive to purchase permanent life insurance protection and would therefore generate tremendous lapses of policies, encouraging individuals to buy term insurance. As I am sure you are aware, term insurance becomes extremely expensive as an individual grows older and, in all likelihood, will be terminated before death. In other words, there will be many widows without benefits who will be relying on the federal government to care for them in the future."

Senator John Heinz (Pennsylvania): "The financial security of many Americans who rely upon life insurance policies could be severely affected by this Treasury proposal. Because of the taxing of the inside buildup, individuals may be unwilling or unable to purchase the life insurance they feel they need for protection. This taxation also might cause policyholders to abandon permanent cash value insurance in favor of term policies, which do not provide the dependability and certainty of permanent life insurance."

Representative Michael Andrews (Texas): "Treasury's current proposal would treat the owners of life insurance as having actually received the cash value which has accumulated during the past year and, therefore, tax this value as income even though policyholder access to 'cash value' is generally in the form of a loan which they must repay with interest."

Representative Bud Schuster (Pennsylvania): "Taxing the annual increased value of life insurance is tantamount to taxing the interest on certificates of deposit although the interest is not received until the certificate matures."

Representative Doug Walgren (Pennsylvania): "Taxing the increase in cash values of life insurance policies is especially troublesome to me, since we have always adopted the approach that income should not be taxed until it is realized."

Representative Bart Gordon (Tennessee): "I promise to oppose legislation which unfairly singles out one segment of our society. For this reason I am against the proposed taxation on 'inside build-up' of permanent life insurance policies."

Senator Edward Zorinsky (Nebraska): "Many have written to me opposing the taxes that, in effect, would be imposed on employer paid health plans and the cash buildup of life insurance. Let me assure that I oppose these changes in the law."

Senator Russell Long (Louisiana): "I certainly agree that life insurance serves important social purposes in our society, and that we must keep those purposes in mind when we consider tax and other legislation. In this connection, in 1984 I opposed the addition of policyholder restrictions to the Life Insurance Tax Act. In particular, I and my Senate colleagues were successful in eliminating the House-passed provision that would have singled out policy loan interest for restrictive tax treatment."

Senator Bob Packwood (Oregon): "As you know, I have been quite active in maintaining the incentives for employee benefits. I am also aware of the potential problems that taxing the buildup of cash values of life insurance and removing the deductibility of loan interest would present to policyholders."

Representative Judd Gregg (New Hampshire): "I would not support the taxation of the inside buildup on insurance policies."

Representative Nancy Johnson (Connecticut): "This tax proposal, in addition, would put insurance beyond the reach of those who need it most. Families struggling to make ends meet would find this added tax burden unacceptable and would forego the valuable protection insurance provides. As the Treasury proposal is a radically new concept and actually taxes "phantom" income--money that the policyholder is unable to use or invest elsewhere--I will oppose it."

Senator Orrin Hatch (Utah): "It is my understanding that, under present law, policyholders benefit principally from the tax free accumulation of cash value under life insurance policies and the deductibility of interest payments for indebtedness. Cash values accumulate under any one of several premium payment systems for whole life insurance which result in larger premium payments than are required to fund current insurance protection. The buildup occurs when a level premium payment plan applies to the policy and the premium payments in the early policy years exceed the current cost of interest rates. In the later years of the contract, the annual cost of insurance is higher, and the nominal face amount of coverage may exceed the annual level premium payment. Under present law, the policyholder is not taxed on increases in the cash value unless the contract is surrendered prior to the death of the insured for an amount in excess of the gross premiums paid. Since Congress has recently studied this issue in depth and made extensive changes in the Internal Revenue Code, it would not be in our best interest to again consider further changes in policy."

Representative Robert Smith (New Hampshire): "I commend the life insurance industry for its cash solvency and I realize how detrimental the taxing of a policy's cash or loan value would be. This is not tax simplification but a blatant discriminatory tax against the insurance industry and is unfair to the individuals who have invested in these insurance programs for personal or family security."

Representative Matthew Rinaldo (New Jersey): "The increase in the cash value of life insurance policies could increase the taxable income of many families and discourage investment in essential life insurance protection."

Representative Mike Synar (Oklahoma): "Americans buy whole life insurance to protect their families and other beneficiaries in the event of death. A tax on the annual increase in cash value--which the insured collects _only if the policy is surrendered_--would increase the cost of this essential component of a family's financial plan. I reject the argument that term life insurance is an alternative. It may be while people are young and premiums are low, but the cost of term insurance increases dramatically with age and, in the end, most Americans will not be able to afford it."

3. THE PROPOSALS ARE UNFAIR BECAUSE THEY ARE AN AFFRONT TO THE CONSTITUTIONAL AUTHORITY THAT ALL TAX LEGISLATION ORIGINATE IN CONGRESS

The founding Fathers of this nation had first-hand experience at being the recipient of tax policy conceived by government and dictated to the people. King George's 1775 edition of Tax Reform and Simplification proved to be extremely unpopular, particularly in the Boston area. Our forefathers realized that the power to tax is the power to destroy. In recognition of that awesome power, the constitution was drafted in order to prohibit any body of government, other than the Congress of the United States, from legislating taxation.

In recent years, it has been the practice of other various branches of governments to attempt to originate tax legislation. The greatest offender has been the Treasury Department. In a totalitarian government the bureaucrats decide on tax policy and dictate the taxes to the people. In a democracy, the elected representative of the people legislate tax policy and dictate that policy to the bureaucrats. Do the views of the bureaucrats in the government and the Treasury Department take precedence over what the people's elected representatives have legislated? Who's running this show anyway--the Congress or the Treasury Department? I urge you to reassert the historical, traditional and constitutional authority that all tax legislation considered by the Senate be the consensus of this Committee and not as a collection of prejudices launched as an unguided missile from the bowels of the Treasury Department.

C. THE PROPOSALS ARE NOT FAIR TO THE LIFE INSURANCE COMPANIES.

1. THE PROPOSALS ARE NOT FAIR BECAUSE THEY CREATE A COMPETITIVE "UNLEVEL PLAYING FIELD"

Life insurance is presently more severely taxed than any other investment vehicle. If an individual buys stocks, bonds, real estate, precious metals, diamonds, options, etc., the unrealized appreciation is not currently taxed. However, when those investments are sold after a holding period of six months of more, any gain received is taxed at the more favorable long-term capital gains rate. A policyowner surrendering his policy back to the company is taxed on any gain (cash surrender value less premiums) as ordinary income. If there is a loss (premiums paid are more than cash surrender value received) the policyowner gets no tax deduction, short or long-term. With these other investments, any losses sustained are tax deductible as either short-term or long-term capital losses.

The proposals incorrectly and unfairly conclude the exact opposite; they state, "Taxing the inside buildup on life insurance policies would eliminate the largest tax distortion in the financial services area and would place competing financial products in institutions on more equal footing." Nothing could be more incorrect.

Assistant Secretary of the Treasury for Tax Policy, Ronald A. Pearlman, stated in a letter to Mr. John J. Creedon, President and CEO of the Metropolitan Life Insurance Company said in February of this year, "Today's sophisticated investors are confronted with a broad range of choices as to where to put their savings dollars. Given their substantial cash management and investment expertise, life insurance companies should be well-positioned to compete effectively in the marketplace for these dollars. We do not believe, however, that it is appropriate to give savings through life insurance policies a tax advantage not available to other forms of investment." Tax advantage! What's the tax advantage of paying non-deductible premiums from after-tax income for a life insurance policy which, if surrendered during the policyholder's lifetime, creates either fully taxable ordinary income or a non-deductible loss?

The proposals also point out that the policyholder buying cash value life insurance could escape taxation on the tax-free buildup all through his lifetime, and, upon payment to his beneficiary at his death, there would be no tax due. That is also true of stocks, bonds, real estate and the other investments previously mentioned. When an American buys stocks and it appreciates in value, at his death the stock takes on a new income tax basis--what the stock was worth at the time of the stockholder's death. If the heirs sell the stock by price equal to the value at the deceased shareholder's death, there will be no income tax due. The same tax truth is applicable to almost every conceivable asset that is included in a deceased American's estate. The heirs take a new tax basis on the asset equivalent to the fair market value of the asset on the date of death of the decedent or the alternative valuation date.

How many of you have received, or heard of one of your colleagues receiving a letter, personal visit, phone call or any other communication from a constituent or any representative of any organization in the financial services and products area complaining about the competitive advantage of life insurance, and how it was destroying the market for their investments? Nobody! Americans view their life insurance premiums as an unpalatable, but necessary expense -- not as an investment. Americans buy life insurance because they love someone and wish to protect them economcially following their death. Although that is an altruistic and admirable motivation, it does not produce white hot, uncontrollable enthusiasm for one to allocate every available extra dollar to more life insurance premiums.

In almost twenty-five years in the life insurance business, less than ten people have ever asked me to buy a life insurance policy.

At a cocktail party, a stockbroker, upon revealing to a stranger his occupation, is plied with questions such as, "What do you think the market is going to do?" "What's your opinion as to the viability of pork bellies as an alternative investment to Ted Turner Fifth Mortgage Bonds?" The life insurance agent, on the other hand, is greeted with responses such as, "I'm insurance poor"; "My brother-in-law is in the insurance business"; I've got all the insurance I need," "I've got to go now, it's been nice to meet you." Representative Stark stated in an interview with the Wall Street Journal, "Who do you know who likes a life insurance agent?" Why? Not because they view the life insurance agent as having industrial strength herpes, but because they view life insurance as a negative expense for protection rather than a positive investment for profit.

2. THE PROPOSALS ARE NOT FAIR BECAUSE THEY CONTINUE THE MASSIVE TURMOIL AND UNSTABLE BUSINESS ENVIRONMENT EXPERIENCED BY THE LIFE INSURANCE COMPANIES DURING THE PAST FOUR YEARS.

The insurance industry has been in absolute turmoil because of the monumental task of redesigning every single one if its policies to meet the "new definition of life insurance" required by the 1984 Congressional reforms of the taxation of life insurance companies and their products. Not only do the policies have to meet the new federal law, but the existing insurance laws of each of the fifty states. The cost of filing and submitting each policy for approval and sale in each of the fifty states is approximately one hundred thousand dollars ($100,000) and requires six months to one year to complete. Only then can the new policy be marketed to see if 1) the agents will sell it, and 2) the public will buy it. A life insurance company does not begin to make a cash profit on a policy until that policy has been in force for a period averaging between seven and fifteen years. The life insurance companies are like medical patients who have just completed major surgery and are trying to recuperate and regain their strength. The life insurance companies desperately need time to settle down and adjust to their new environment following their compliance with last year's new tax law. The rest of American Business and Industry will have to analzye, redesign, implement and adjust their business as required by probable revision of the entire tax system. The life insurance companies have already done this and should not be put through the ringer again.

D. THE PROPOSALS ARE NOT FAIR TO THE LIFE INSURANCE AGENTS.

1. LIFE INSURANCE AGENTS, MARKETS, PRODUCTS AND POLICYOWNERS HAVE BEEN UNDER THREE CONTINUOUS YEARS OF NEGATIVE TAX CHANGE BOMBARDMENT.

Americans don't buy products clouded in the grey mists of tax uncertainty. They delay, they put off, and rightfully so. Who can buy something that requires at least a psychological commitment of 10, 20, 30 years, not knowing what the tax results will be? Trying to market life insurance during the past three years of tax bombardment is equivalent to trying to sell subdivision lots in the midst of an earthquake.

2. THE PROPOSALS ARE UNFAIR, NOT BECAUSE THEY DESTROY THE MARKET FOR LIFE INSURANCE, BUT BECAUSE THEY DESTROY THE PRODUCT OF LEVEL PREMIUM LIVING CASH VALUE LIFE INSURANCE.

Agents have lost major markets for life insurance, properly or improperly, due to congressional enactment of the recommendations of the Treasury Department in their continuing attack on life insurance. Permanent Cash Value Section 79 Life Insurance is a thing of the past. Permanent cash value life insurance purchased by Voluntarily Employee Beneficiary Associations (VEBA'S) are no longer viable. Retired Lives Reserve (RLR) formerly provided post retirement paid-up death benefits for retired employees, but no more. Benefits to policyholders provided by these vehicles were destroyed by tax legislation.

The insurance industry can always adjust to a market for life insurance being destroyed, but it cannot adjust to the product of life insurance being destroyed. That is the MOST IMPORTANT CONCEPT that will be contained in my testimony.

3. THE PROPOSALS ARE UNFAIR BECAUSE THEY WILL DESTROY A MAJOR SOURCE OF PRESENT AND FUTURE EMPLOYMENT FOR AMERICANS.

There are approximately 400,000 licensed life insurance agents, divided approximately equally between full-time and part-time. Agents are paid sales commission equal to approximately 50% of the first annual premium on a policy. Agents are paid service commissions of approximately 5% of the annual renewal premium for the first ten years and 2% thereafter. In the example of the 35-year-old father purchasing the $40,000 policy for $535 of annual premium, a typical agent's commission would be $267.50 the first year; $26.75 for years two through ten; and $10.70 for years eleven on. Assuming that the 35-year-old lived to age 75 (40 years), the agent would have received $856 of commissions over the 40-year life of the policy, which represents four percent of the total premiums paid over 40 years of $21,400.

In order for an agent to earn first year gross commissions of $25,000, the agent must have life insurance sales with annual premiums of $50,000. It doesn't matter whether the insurance is permanent or term, because agents are paid on premium, not volume.

Assuming that the average age of his new policyholders is age 35, this will require sales of approximately $3,738,000 of permanent cash value life insurance or over $33,898,000 of increasing premium yearly renewable term. I hope what is traumatically apparent to agents, and their employees, is now obvious to you. If the proposals pass, term insurance will be the only viable product. An agent would have to sell ten times as much term insurance as permanent insurance just to break even. Life insurance agents and their employees will be economically devastated.

Even under present law, the job of selling life insurance is one of America's most difficult occupations. Out of ten new life insurance agents hired, only one will survive for five years. A successful agent generally has to make 40 calls to see 20 people, in order to have 10 meetings, to get 5 closing sales interviews, to make 2 sales. The only way you could get an equivalent feeling of the rejection and obstacles agents must overcome in order to sell life insurance would be for you to solicit contributions for the United Jewish Appeal in Tehran. The only occupational group that has a higher job mortality than life insurance agents was the first platoon to hit Anzio. The insurance companies estimate that the cost of hiring and training a new agent is approximately a quarter of a million dollars, and it takes ten new agents hired to keep one.

If the agency force of this nation is destroyed and forced into other areas of economic endeavor, even if Congress ultimately rectified the situation back to current law, the damage would be enormous. Approximately 400,000 life agents, and 600,000 insurance employees, assuming three persons per family, almost 3 million Americans would be economically crushed. As they say in Louisiana, "From the time you plant it, it takes a pecan tree seven years to bear no matter how bad you want a pie."

III.

GROWTH

A. THE PROPOSALS ARE NOT GROWTH PRODUCTIVE BECAUSE THEY WILL NEITHER CURRENTLY NOR ULTIMATELY PRODUCE ADDITIONAL TAX REVENUE.

1. THE 200 MILLION OF PROJECTED REVENUE IN 1990 FROM THE TAXATION OF PERMANENT CASH VALUE LIFE INSURANCE WILL NEVER HAPPEN.

The Treasury Department always makes a fundamental error in their assumptions in projecting tax revenue that the economic activity of the nation is going to stay the same. Assuming that people will continue to buy level premium permanent living cash value life insurance burdened by these onerous new taxes, is equivalent to assuming that the number of people going to the beaches will remain the same regardless of the number of sharks in the water. Plain, old fashioned, common horse sense dictates that nobody will buy policies which create a tax cost in addition to non-deductible premiums. If no premiums are sold, no new tax is created. "Where's the beef?"

2. THE $400,000 MILLION OF PROJECTED REVENUE BY 1990 FROM THE TAXATION OF ANNUITIES WILL NEVER HAPPEN EITHER.

Annuities are not life insurance. Most annuities are bought as investments with capital created from some other form of economic endeavor. The vast majority of annuities are not paid on an annual premium basis, but rather are Single Premium Deferred Annuities (SPDAs). I don't think most life insurance agents would know an annuity if it walked up and bit them on the leg. Other than a sale for an IRA or a qualified pension or profit sharing plan, I don't think I have ever sold anyone an annuity in 25 years. Most annuities are sold by the "investment" people such as stock brokers. If you tax the unrealized appreciation of an annuity you will not destroy the creation of capital, but you will destroy existing tax revenue. How? Because who's going to buy an annuity that will produce annually increasing taxable income when they can buy a tax-free bond fund that will not only accumulate income tax-free, but distribute tax-free as well? Under current law, when the annuity owner cash surrenders his annuity he must pay ordinary taxable income on the gain (cash surrender value received less total premiums paid). If there has been a loss, as frequently occurs with an equity based annuity, it can neither be deducted from ordinary taxable income nor capital gain, either long or short-term.

I really can't see why anybody would buy an annuity now compared to a tax-free bond fund, but who can question the financial wisdom of the stockbroker? The point is, that if, in addition to the other tax disadvantage currently suffered by annuities, there is a new tax levied on the unrealized appreciation of the annuity, the majority of the people will buy tax-free bond funds and the government will not only never realize the projected future revenue, they won't get the tax they get now when an annuitant cashes in or begins to receive payments from his annuity.

The Treasury Department estimates that the new tax on annuities will produce "negligible" revenue in 1986, $100 million in 1987, $200 million in 1988, $300 million in 1989, and $400 million in 1990. The only 400 million of anything I can see accumulating by 1990 is the number of unused bank deposit slips at the Treasury Department.

3. THE PROPOSALS ARE COUNTER-GROWTH PRODUCTIVE BECAUSE THEY WILL CREATE A NET TAX REVENUE LOSS IN 1986!

If the conclusions of the experts both in and outside of the insurance industry are correct, the proposals, if enacted, will be devastating to the incomes of the insurance companies, agents and employees. It is equally true that the proposals, if enacted, will be devastating to the tax revenue currently being paid by the insurance companies, agents and their employees. This esoteric economic theory is based on the premise that, "If we ain't got no income, we don't pay no tax."

4. ALTERNATIVE SOURCES OF TAX REVENUE FOR THE NATION

In order to keep the president's tax proposals "revenue neutral," any changes by Congress in the President's proposals that result in loss of projected tax revenues has to be made up somewhere else.

If push comes to shove, and in the final analysis there is no other way but to wring the additional revenue out of the life insurance industry, consider the suggestion of Representative Stark. He asked Secretary of the Treasury Baker, in hearings before the House Ways and Means Committee, if the Administration would be willing to simply adjust the taxable income formula that was established last year to raise additional revenue from the insurance industry. Secretary Baker's answer to Representative Stark was that the Administration would listen to suggestions to adjust last year's rates.

Representative John Breaux (Louisiana) stated on May 18, 1985, "It has been reported that the latest income tax returns of 165 of the nation's largest corporations revealed that they paid no income tax. Included in this number was General Electric, which earned $6.5 billion of income and not only paid no tax, but received a $293,000 refund. Assuming that the proposed 20% alternative minimum tax for corporations would be applicable to this income, the new revenue raised would be in excess of $1.2 billion from General Electric alone. This is $600 million more from this corporation alone in current increased tax revenue, than taxing every life insurance policyowner and annuityowner in the nation is supposed to produce by 1990! Possibly there should be a progressive alternative minimum tax increase not only on the amount of the corporation's income, but also on the number of previous years for which the corporation has paid little or no tax. Isn't it more fair to tax the "big boys" who have paid little or no tax?

It has also been discussed that the legitimate tax due on the unreported income generated by the underground economy could approach $100 billion.

Devoting the time, energy and resources of the Treasury Department and the United States Congress to obtain negligible or unmeasurable amounts of revenue, by taxing individuals on their life insurance while we as a nation are hemorrhaging over the billions in the budget deficit, is analogous to calling out the National Guard to pursue parking meter collections while murderers, rapists, and felons run wild in the streets.

B. THE PROPOSALS ARE COUNTER-GROWTH PRODUCTIVE BECAUSE THEY WILL REDUCE ECONOMIC GROWTH BY SLOWLY DESTROYING $56,000,000,000 OF NEW CAPITAL FORMATION.

1. THE PROPOSALS ELIMINATE THE NEW CAPITAL FORMATION FROM THE SALE OF NEW POLICIES.

The policyholder's living cash values which buildup on a tax-deferred basis in whole life policies are a major source of capital formation in our national economy. In 1983 alone, the life insurance industry contributed $56.5 billion to the U. S. capital markets including government securities, corporate stocks and bonds, public utility and railroad bonds, mortgages and real property. If nobody buys level premium living cash value life insurance because of the new tax, there will be no new capital created from the sale of new policies. Like capital created from some other source that will automatically have to be reinvested "somewhere", loss of created capital resultant from the lack of continuing new level premium permanent life insurance will be almost a total loss. Why? The reason is, again, that life insurance premiums are paid as an expense. They are paid and viewed as a bill, not an investment. In absence of this "forced savings" method of paying premiums, the capital that would otherwise be created will in all probability be spent on increasing the individual standard of living and not on investment. The real competition to the sale of life insurance is not other investments, but some other current enjoyment the individual could purchase with his money. New capital will not be created because amounts not saved through the discipline of regular premium payments will be spent for consumption.

2. THE PROPOSALS WILL NOT PRODUCE ECONOMIC GROWTH BECAUSE THEY WILL CREATE A "UNLEVEL PLAYING FIELD" BETWEEN NEW POLICIES PURCHASED AND EXISTING POLICIES GRANDFATHERED.

There is at present approximately 600 billion dollars of living cash values of life insurance policies in the capital of our national economy. Many of these policies are not consumer-oriented. The insurance companies for years paid the policyowners only nominal rates of interest and dividends. For decades, the insurance companies extolled the virtues of guaranteed interest rates and conservative dividend projections to the policyholders and the agents. Fifty years of this insurance company "mumbo jumbo" resulted in a consumer return to the American policyowners of approximately 2½-5% per annum. During the last decade, when interest rates began to escalate, many of the more aggressive insurance companies developed "interest-sensitive" products which gave the policyowner not only the guaranteed rate of interest, but an additional current market rate of interest determined either by the Board of Directors or some outside index such as Moody's Bond Index, etc. This was a great boon to the consumer. Life insurance became cheaper and could be paid up quicker. Not only was more life insurance purchased, policyholders began cashing in their old policies with poor returns in order to buy new policies with greater yields. This is, of course, what makes the American economy what it is. If a business competitor can provide a better product to the American consumer quicker, better, or for less cost, he gets the business, the consumer gets a better deal, and the whole economy benefits. Who does it not benefit? The old purveyor of the inferior product or service -- and that's the way it should be.

The Treasury Department realized that if they had attempted to have Congress pass legislation that taxed the unrealized appreciation of all policies, there was a strong probability of creating a political firestorm for a relatively minor amount of revenue that could seriously damage the chances of passing the overall proposal. Therefore, by proposing to tax only new life insurance policies, the political risk to expected public opposition was reduced.

By grandfathering existing life insurance policies from taxation of the unrealized appreciation, existing American policyowners are locked into their old policies without the opportunity to improve their coverage through increased benefits or lesser costs. Many American policyowners are uninformed and still have old, out-of date policies that border on financial "rip-offs." This is especially true because of today's economic conditions and the financial attractiveness of the new interest sensitive insurance products. No level premium life insurance policy can survive as a viable financial instrument with the malignancy of taxation internally destroying the unrealized appreciation of the policy. No policy should be taxed on the unrealized appreciation, but if new policies are taxed, existing policies, no matter how financially inferior, will be kept by the policyowners which is counter-growth productive to the proper allocation of the nation's resources.

C. THE PROPOSALS ARE NOT GROWTH PRODUCTIVE TO THE 50 INDIVIDUAL STATES BECAUSE THEY WILL ERODE EACH STATE'S LIFE INSURANCE PREMIUM TAX

Life Insurance Fact Book (ACLI) reports that for 1983, state governments collected $1,551,000,000 of revenue from life insurance premium tax income. If the proposals are passed, little or no permanent level premium cash value life insurance will be purchased. Level premium life insurance has premiums higherthanterm. Ifthepublicbuys just low premium term insurance, which they will sooner or later have to discontinue, the state's revenue base from premium taxes will be eroded.

One of the major revenue producers of the President's proposals is eliminating payment of state and local taxes as a deduction from taxable income. Assuming those proposals pass, state and local governments will be hard pressed to increase or even retain their revenue base. What do they not need at the same time is a decline in one of their major sources of income, the state life insurance premium tax.

IV.

SIMPLICITY

A. THE PROPOSALS ARE NOT SIMPLE BECAUSE THEY INCREASE THE COMPLEXITY OF THE CALCULATION OF LIFE INSURANCE POLICY TAXABLE INCOME

1. THE SIMPLICITY OF CURRENT LAW

The premiums paid by the policyowner are non-deductible expenses paid from his after-tax income. During his lifetime, unless and until he cash surrenders his policy, there is no taxable income. Should the policyholder cash surrender his policy, any gain is taxed to him in the year the policy is surrendered as ordinary income. The gain is determined by subtracting the net premiums paid by the policyowner during his lifetime from the gross cash surrender proceeds received, and the difference is either a gain taxable as ordinary income or a loss which is neither deductible as an ordinary or capital short- or long-term loss. Simple.

2. COMPLEXITY OF THE PROPOSED LAW

The policyholder would be taxed on the unrealized appreciation on his level premium life insurance policy each year in which there is taxable income. Taxable income is determined by first determining the cash value cost, a brand new concept in tax legislation. The cash value cost is determined by subtracting the cashless imputed phantom income of an equivalent premium for a one-year term policy for the period of time the policy has been in force from the total net premiums paid by the policyowner to date. Then you subtract the cash value cost from the increase in the unrealized living cash surrender value for the year and the result equals taxable income for the year. Just think of the beauty of it all. Millions of Americans will be able to experience the thrill of recomputing these figures with their handheld calculators in order to verify the information received from the government and the insurance companies.

Sixty-five percent of our current taxpayers do not itemize their deductions. However, if the current proposals to tax life insurance become law it should create for them the impression of fairness due to the fact that they will be able to spend two or three days trying to figure this mess out with the rest of us. Perhaps it could be expressed algebraically: V - (P - D - T) = TI. Or, cash surrender value MINUS (cumulative premiums paid MINUS cumulative dividends received MINUS cumulative imputed one-year taxable term economic benefit) EQUALS taxable income, or non-deductible loss. Eureka! Hooray for simplicity! The fellow that thought up this if asked to determine a method for determining the number of cattle in a herd would probably reply, "Count their legs and divide by four!"

B. PROPOSALS ARE NOT SIMPLE BECAUSE THEY WILL INCREASE THE COST AND COMPLEXITY OF TAX ADMINISTRATION, COMPLIANCE, REPORTING AND FILING.

1. THE PROPOSALS ARE NOT SIMPLE BECAUSE THEY WILL INCREASE THE COST AND COMPLEXITY OF TAX ADMINISTRATION, COMPLIANCE, REPORTING AND FILING TO THE POLICYOWNERS

Most policyowners do not understand life insurance or its terminology now, much less if the proposals are passed. They will not understand what they have received when they get a 1099 or similar tax reporting slip from the insurance company that tells them they must report taxable income from their insurance policy. They will realize that they did not receive any cash, and so the questions will start: "Was I supposed to get this much in cash?", "Was my check sent somewhere else?", "Am I going to get a new check?", "If I didn't get a check, how come I have to pay tax on this amount of income?", "How is that determined?", "Are you sure they can do this?", "Who say's so?", and on and on. If there is no agent to run interference for the policyholder, his chances of getting correct and timely information are slim and none--and Slim just left town. The only organization that I know that approaches a government agency in the degree of difficulty, exasperation and length of time necessary to get accurate information is a life insurance company. Just for fun, pick out one of your life insurance policies, phone the life insurance company direct and ask whoever answers the phone the most simple question you can think of, such as, "Who is the beneficiary on my policy number 1234?" You will be switched endlessly from one person to another until you are either disconnected or receive the reply, "We'll have to get back to you with that information."

God help the policyholder if the insurance company's computer system screws up in reporting his taxable income. If he doesn't have a good agent, the poor policyowner will never get it straightened out.

2. THE PROPOSALS ARE NOT SIMPLE BECAUSE THEY WILL INCREASE THE COMPLEXITY OF TAX ADMINISTRATION, COMPLIANCE, REPORTING, CALCULATION AND FILING FOR THE INSURANCE COMPANIES.

Insurance companies will have to develop new computer systems, new administration systems, and new staff people in order to comply with what will assuredly be the burden of reporting the taxable income on policies to the policyowners. The insurance company's computer will have to store all of the information on all of the policies for all of the previous years. It is going to be a hopeless tax morass for all concerned.

Several years ago I was staying at the Hilton in Baton Rouge, Louisiana. The following morning I was intent on check out of the hotel and getting on the road as soon as possible. Upon entering the lobby, I was surprised to find lines of nuns stretching all the way from the cashier's window, through the lobby, and down the hall. When I inquired as to what had happened, it seemed that there had been a lightning storm the previous evening. Each room is equipped with a private bar which would dispense miniature bottles of liquor upon pushing the right button and electronically add the charge to the occupant's bill. The hotel was filled with nuns attending a convention. Apparently, during the storm of the previous evening, every time a bolt of lightning was discharged in the area, the hotel's computer electronically added a liquor charge to every room in the place. The nuns didn't find out about it, of course, until they were checking out, and boy they were upset! If you multiply the nun situation times millions of policyholders, you have some idea of what it will be like during tax seasons in the insurance business should these proposals pass.

3. THE PROPOSALS ARE NOT SIMPLE BECAUSE THEY WILL INCREASE THE COST AND COMPLEXITY OF TAX ADMINISTRATION, COMPLIANCE, REPORTING, CALCULATION AND FILING FOR THE LIFE INSURANCE AGENT.

The agent is the "Champion" of the policyowner. Policyowners are the source of an agent's income, not the insurance companies. If the policyholder is not happy with the product, the company, the government, or anything else, the agent is going to catch the dickens first and be required and held accountable to get the thing straightened out. If the agent does not get whatever problem comes out resolved to the satisfaction of his policyowner, he runs the risk of losing any new sales and the possibility of the policyowner cancelling his policy and costing the agent renewal commissions as well. Obtaining and verifying correct information concerning my client's policies to be used in their annual corporate and personal filing of their tax returns requires the majority of my staff's time during the months of January and February. Gwen Havens, the office manager for Cox and Company and a wonderful friend and lady, starts complaining in

November about the impending "tax season" and doesn't stop until it's over in March. It's going to be a mess. I would sooner swim laps in a pool full of molassas than to go through what we're going to have to contend with during tax season.

Many people have the mistaken impression that a life insurance agent has no expenses. This is not correct. The life insurance agent is involved in a personal service business and typically spends from 25 to 50% or more of his gross first-year and renewable commission on the expenses of running his business, just like any other professional. These costs will increase dramatically for the life insurance agent should the proposals become law.

5. THE PROPOSALS ARE NOT SIMPLE BECAUSE THEY WILL INCREASE THE COST AND COMPLEXITY OF TAX ADMINISTRATION, COMPLIANCE, REPORTING AND FILING TO THE FEDERAL AND INDIVIDUAL STATE GOVERNMENTS.

The Treasury Department, in order to promote growth, fairness and simplicity in the processing of America's tax returns, installed the Internal Revenue Services' new mammoth computer system. The result was that the processing of our tax returns, tax deficiency notices and tax refund checks suffered massive delays. Apparently the system caught the hiccups, or something, and just didn't do what it was supposed to. Not only did it not do what it was supposed to do, it was slower than the old system. If you think that's slow, wait until it ingests millions of additional, unfathomable policyholder 1099s that nobody can make heads or tails of. I can see the computer form letter from the IRS now:

> April 1, 1988
>
> Dear Mr. Policyowner,
>
> We have examined your return for the year 1985, and determined that there is a discrepancy between the amount of income you reported and that cross-referenced by our computer. We are in receipt of a copy of a 1099 in the amount of $500 resultant from your policy number 2734 issued by the Night Life of New Orleans.
>
> Please forward your check to the Internal Revenue Service in the amount of $850.00, which includes penalty and interest.
>
> Sincerely,
>
> Ima Auditor
> Internal Revenue Service

The agent's phone rings: "I'm going to kill you. I want you over here right now and straighten out this mess with the IRS. This insurance policy you sold me has screwed up my taxes and now it's going to cause me an IRS audit. Do you know what you can do with your policy? (expletives deleted)."

I recently received a taxable income notice from the Internal Revenue Service which gave no indication of what it was, where it came from, or why they were sending it. Gwen Havens, my office manager, has spent hours on the phone with people in the Internal Revenue Service trying to find out why they sent it to us. They said they didn't know. They told me that if I would write a letter they would find out, but that it would take two years! In the meantime, I had to pay the tax, interest and penalties.

What in the world is it going to be like in Federal and State Governments, processing the taxable income from millions upon millions of individual insurance policies?

V.

CONCLUSION

"IF IT AIN'T BROKE, DON'T FIX IT!"

APPENDIX A

$1,551,800,000

1983 STATE LIFE AND HEALTH INSURANCE PREMIUM TAXES

Alabama	35,800,000	Missouri	23,900,000
Alaska	4,000,000	Montana	6,700,000
Arizona	19,200,000	Nebraska	12,500,000
Arkansas	14,800,000	Nevada	7,400,000
California	171,000,000	New Hampshire	5,100,000
Colorado	26,200,000	New Jersey	40,400,000
Connecticut	22,600,000	New Mexico	10,100,000
Delaware	5,000,000	New York	61,700,000
D.C.	9,500,000	North Carolina	47,800,000
Florida	79,700,000	North Dakota	3,600,000
Georgia	47,300,000	Ohio	92,100,000
Hawaii	9,600,000	Oklahoma	42,800,000
Idaho	7,200,000	Oregon	15,500,000
Illinois	88,900,000	Pennsylvania	64,900,000
Indiana	35,300,000	Rhode Island	4,400,000
Iowa	20,600,000	South Carolina	21,700,000
Kansas	15,800,000	South Dakota	6,400,000
Kentucky	19,700,000	Tennessee	31,400,000
Louisiana	29,500,000	Texas	98,500,000
Maine	5,600,000	Utah	10,000,000
Maryland	24,600,000	Vermont	2,700,000
Massachusetts	34,600,000	Virginia	42,100,000
Michigan	52,900,000	Washington	24,100,000
Minnesota	25,900,000	West Virginia	16,400,000
Mississippi	22,400,000	Wisconsin	27,900,000
		Wyoming	4,000,000

Source: American Council of Life Insurance

STATEMENT OF FRED A. DEERING, CHAIRMAN OF THE BOARD, AND CHIEF EXECUTIVE OFFICER, SECURITY LIFE OF DENVER, DENVER CO, ON BEHALF OF THE ASSOCIATED LIFE INSURANCE GROUP NATIONAL POLICYHOLDER ADVISORY COMMITTEE

Mr. DEERING. It's a hard act to follow, Mr. Chairman, and I will forgive the discrimination between the State of Colorado and the State of Louisiana. [Laughter.]

Mr. DEERING. My name is Fred Deering. I am chairman of the board and chief executive officer of Security Life, a medium-size life insurance company in Denver; and a past chairman of the Life Office Management Association, which is comprised of some 700 companies throughout the United States.

We are beginning to feel like a pointman in the infantry platoon because we think that the life insurance industry has led the parade of tax reform, starting, as Senator Long said earlier, in 1982 with TEFRA; followed by 1984 with the Deficit Reduction Act. The life insurance industry has been subject to a parade of tax reforms, if you will.

In August 1984 when the Deficit Reduction Act was finally signed, we breathed a long sigh of relief because we believed we were able now to concentrate again on designing and selling our products in the stable tax environment which is essential to any kind of long-range financial commitment. Now as part of its general tax reform plan, the administration is proposing once again to make drastic changes in the way cash-value life insurance is taxed to the policyholder.

Reforming life insurance taxation for the second time in 2 years is not only totally unnecessary; it is devastating to our industry, which is dependent upon long-term predictability and stability in the Tax Code. We are reformed. We are going straight. Please leave us alone.

The President's tax reform proposal would, for the first time in history, include increases in the value of ordinary life insurance policies, the inside buildup, in the taxable income of policyholders. That would harm moderate income people and force them to abandon one of the pillars of their financial security; namely, permanent life insurance.

There now seems to be a widespread consensus on Capitol Hill that taxing the inside buildup would, in fact, be wrong. My prepared testimony deals in depth with the consequences of taxing inside buildup because until last Thursday, September 26, that was the major issue facing consumers of life insurance.

But with the Ways and Means staff proposal, we have a new ball game. So I would like to use my limited time here to point out why the Ways and Means option is equally bad for the companies and for the policyholders. We are all going to be the losers.

On September 26, Ways and Means staff gave us what looked like some good news. Namely, no direct tax on the inside buildup. But the bad news is that the changes which they have proposed in return will have an even more crippling effect on whole life insurance. Generally under the Ways and Means staff proposal, policy loans will no longer be treated as loans. Instead, they will be treated as ordinary income to the policyholder to the extent of the inside buildup. This is just a backdoor way of doing what the growing consensus here opposes—taxing the inside buildup.

Second, and this is the real clincher, interest paid on the policy loan would be completely nondeductible. This proposal is similar to, but far worse than, the limitation on loan interest deductibility which was rejected last year by this committee and by the conference committee. We think you were right last year. You acted in the best interest of millions of policyholders, present and future.

One of the major reasons people purchase whole life insurance is because they have access to their cash value without restrictions or penalties. Take this right away or severely restrict its use and you will effectively destroy whole life insurance. Millions of middle income families, farmers and small business owners will simply not purchase the product for financial security if they are unable to reach their cash values by policy loans without paying severe penalties to do so. This means permanent whole life insurance will simply not be sold. Instead, term insurance will be sold. But we know term insurance is not the answer to family or business security. It becomes prohibitively expensive as the policyholder ages; it creates no residual cash values to keep the policy in force if the insured is unable to pay premiums; and it fails to meet the essential element of life insurance as a permanent solution.

This is borne out by the fact that statistics show us that 95 percent of all term insurance sold lapses before the policyholder dies.

There is another severe disadvantage to the elimination of whole life insurance. Over the years, it has been a primary accumulator of capital, pouring $56 billion into the American economy from policyholder funds in 1983, a figure which will probably be $60 billion in 1984.

Speaking from personal experience, I can say that these provisions will almost surely terminate the sale of whole life insurance policies. Although it's only been 5 or 6 days since September 25, we've seen a striking decline in our sales of whole life insurance since that time.

The CHAIRMAN. I will have to ask you to conclude, Mr. Deering.

Mr. DEERING. I will wind up.

When the administration set out on the road to tax reform its avowed purpose was to reach results which were fair, simple and would promote economic growth. Taxation of the inside buildup and limitations on loan interest deductibility and now the insidious alternatives offered by the Ways and Means staff do not achieve any of these objectives. These proposals are not fair; they are not simple; and far from promoting economic growth, they are guaranteed to seriously impair, if not destroy, one of the greatest capital accumulation mechanisms in economic history.

We urge you to continue to protect policyholders from taxation of their life insurance.

And I appreciate the privilege of being here today, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Deering follows:]

STATEMENT OF

ASSOCIATED LIFE INSURANCE GROUP NATIONAL POLICYHOLDER ADVISORY COMMITTEE

BY

FRED A. DEERING

ON

TAX REFORM PROPOSALS AFFECTING LIFE INSURANCE

BEFORE THE

COMMITTEE ON FINANCE

OCTOBER 1, 1985

SUMMARY

Just last summer Congress completed a comprehensive overhaul of life insurance taxation after more than two years of careful study. These reforms, which were incorporated into the Deficit Reduction Act of 1984, included the tax treatment of life insurance products as well as of companies. This year, as part of its general tax reform plan, the Administration is proposing once again to make drastic changes in the way cash value life insurance is taxed to the policyholder, and also in the way that life insurance companies are taxed. "Reforming" life insurance taxation for the second time in two years is totally unnecessary, and would fail to achieve any of tax reform's stated goals: fairness, growth and simplicity. In fact, if the changes now being proposed were adopted, the results would be contrary to these goals.

New Taxation of "Inside Build-Up"

Most of the tax reform proposals now before Congress would, for the first time in history, either directly or indirectly, include annual increases in the value of ordinary life insurance policies in the taxable interest income of policyholders. In the calculation of the amount of taxable income, the policyholder's basis (investment) in the contract would be reduced by the imputed cost of term insurance protection. Under this formula, as policyholders age and the imputed cost of this theoretical term component escalates, their basis would be forced down, exposing ever-increasing amounts to taxation every year.

Advocates of these proposals fail to take into account that:

- taxing life insurance in this manner would be a radical departure from long-standing tax policy which recognizes taxable income only in the event of actual or constructive receipt. Annual increases in the cash surrender value of whole life insurance should not be treated as income because policyholders cannot access these funds without sacrificing all or part of the death protection provided. Unlike debt instruments, surrendered life insurance cannot be replaced unless the policyholder is insurable.
- whole life insurance is not an investment vehicle. Its purpose is to provide economic protection against the risk of death at a cost that remains level even as the policyholder ages. This level cost feature, which is funded by the inside build-up, distinguishes term from whole life insurance. Whole life insurance is much more likely to remain in force and benefit survivors than is term insurance. Because of the rapid escalation in the cost of term insurance as people age, more than 95% of all term policies are discontinued by insureds and pay no death benefit.
- whole life insurance is not a tax loophole for the wealthy. The new definition of life insurance enacted last year eliminated the possibility of tax-sheltered investments being disguised as life insurance. The proportion of life insurance

held by the wealthy in relation to their other financial assets is small. This profile is reversed for moderate and middle income Americans. The income of 61% of those who own whole life is less than $25,000 per year. These are the very people who already pay their fair share of taxes and can least afford either the costs which would accompany the taxation of inside build-up, or the consequences of inadequate coverage.

- taxing inside build-up would be extremely complex and expensive to administer.

- taxing inside build-up would be particularly burdensome to the aged, because the cash value of whole life increases most rapidly after age 60 so that premiums can stay level. The imputed value of term coverage also escalates rapidly after age 55, which would reduce the basis in the contract and thereby add significantly to the taxable income of the elderly.

- taxing inside build-up would virtually eliminate the life insurance industry's ability to contribute to capital formation. In 1983 alone, life insurance contributed $56.6 billion to U.S. capital markets, made possible largely by the cash values in millions of whole life policies. Such contributions would become greatly reduced in the future under the proposals to tax these values.

- taxing inside build-up would result in long-range hidden costs as demands would ultimately be placed on social service and welfare programs of the federal government to provide what individuals have heretofore been able to provide for themselves.

Loan Interest Deductibility

Deductibility of interest paid on life insurance loans would be restricted under the Administration's general consumer loan interest deductibility provisions. These provisions limit personal loan interest deductions to $5,000 in excess of total investment income (in addition to interest paid on primary residence mortgages). For instance, if an individual had $10,000 in investment income and $12,000 in total loan interest payments from all sources (other than home mortgages), all interest payments would be deductible. If the same person had no investment income, only $5,000 of the interest payments would be deductible.

Restrictions on the deductibility of personal borrowing should be dropped for the following reasons:

as long as full interest deductibility is permitted for some kinds of borrowing (i.e., mortgages, business loans), taxpayers will restructure their loans to take advantage of safe harbors. The end result will simply be disintermediation, without any net change in consumption versus savings. If the purpose in limiting loan interest deductibility is to reduce consumption and encourage savings, the Administration's provision will not achieve it.

- the ability to deduct loan interest makes it possible for people to meet financial emergencies without surrendering their assets, including life insurance policies.

- under current law, the option to borrow against a life insurance policy should not be confused with actual behavior. While the ability to borrow against a whole life policy, should it become necessary, encourages people to purchase whole life rather than term, despite whole life's initially greater expense, relatively few policyholders exercise this option. Even in recent difficult economic times (and prior to the enactment of the new restrictive definition of insurance) loan activity nationwide has remained stable at about 28%.

STATEMENT OF FRED A. DEERING

ALIGNPAC (Associated Life Insurance Group National Policyholder Advisory Committee), formed in 1982, is comprised of thousands of life insurance agents and financial planning agencies from all over the United States. They, in turn, represent the interests of tens of thousands of individual policyholders. While our membership is in some ways diverse, we are all engaged in helping individuals plan for their long-range financial security. Many of our members also design and implement employee benefits packages for businesses both large and small.

Like millions of other policyholders, our clients own life insurance to provide themselves with a hedge against disaster. Life insurance guarantees a flow of income, maintenance of home ownership, college educations, and sometimes simply economic survival when a family provider dies. Many of our clients are farmers, ranchers, and small business owners who rely upon their life insurance to guarantee that these family enterprises can continue intact and not be liquidated to pay estate taxes.

Only last summer, Congress completed a total overhaul of life insurance taxation after more than two years of careful study. These reforms, which were incorporated into the Deficit Reduction Act of 1984, included the tax treatment of life insurance products as well as of companies. This year, as part of its general tax reform plan, the Administration is proposing once again to make drastic changes in the way cash value life ~~insurance~~ is taxed to the policyholder, and also in the way that life insurance companies are taxed. "Reforming" life insurance taxation for the second time in two years is not only unnecessary, but would also fail to achieve any of tax reform's stated goals: fairness, growth and simplicity. In fact, if the changes now being proposed were adopted, we believe that the results would be contrary to these goals.

We appreciate this opportunity to express our deep concern over the impact that the Administration's and other tax reform proposals would have on our clients, ourselves, our industry, and the U.S. economy as a whole.

TAXATION OF THE "INSIDE BUILD-UP"

Most of the tax reform proposals now before Congress would, either directly or indirectly, include annual increases in the value of ordinary life insurance policies in the taxable interest income of policyholders. In the calculation of the amount of taxable income, the policyholder's basis (investment) in the contract would be reduced by the imputed cost of term insurance protection. Under this formula, as policyholders age and the imputed cost of this theoretical term component escalates, their basis would be forced down, exposing ever-increasing amounts to taxation in each successive year.

ADVOCACY OF SUCH A TAX REFLECTS A MISUNDERSTANDING OF THE NATURE AND PURPOSE OF WHOLE LIFE INSURANCE.

" Whole life insurance is not an investment vehicle, nor is it a tax loophole for the wealthy. On the contrary, the concept of whole life insurance as we know it today originated in England in the 1700's as a response to the inadequacies of term insurance. Many people were dissatisfied with term insurance as a means of providing economic security for their families because it became too expensive to maintain into old age. More often than not, insureds were forced to let their term policies lapse because they couldn't afford the rapidly escalating premiums. This is still true today: more than 95% of all term insurance is allowed to lapse before any claim can be made against it.

To remedy this major shortcoming, whole life was structured so that the premiums would remain level over the duration of the policy. Companies accomplished this by collecting higher premiums than needed to cover the risk of death in the early years, and investing the difference. Earnings on these investments ("inside build-up") funded the eventual death benefit without raising costs to policyholders as they aged. This system worked so well in England that by the 1840's--some 75 years before the advent of the income tax--it had become well established in the U.S. as well. By providing insurance that could "go the distance", whole life met--and continues to meet--the financial security needs of the common person. The wealthy, then as now, had the resources to provide for themselves and their families without the help of life insurance.

Industry statistics clearly demonstrate that whole life insurance is used primarily by families with moderate to middle incomes to provide economic protection against the risk of death at a cost that remains level even as the policyholder ages. According to the American Council of Life Insurance, about two-thirds of the whole life policies purchased in 1983 were on the lives of individuals with family income of under $25,000 per year. Their policies, which average about $19,000, are typically held for two to three decades. In contrast, only about one-third of whole life policies are purchased by families with over $25,000 in annual income. Even more significantly, as income gets higher, the proportion of whole life insurance as a percentage of total financial assets drops markedly. The new definition of life insurance enacted last year eliminated the possibility of tax-sheltered investments being disguised as life insurance. Wealthier individuals invest their money in stocks, mutual funds and tax-exempt bonds--not life insurance.

It is interesting to note that the need to assure that costs do not escalate over the years beyond eventual means to pay is also what motivates people to own rather than to rent their homes, even if it means being cash poor to cover the initially higher costs of ownership. The ability to deduct interest on mortgages and other tax benefits associated with home ownership helps to bring down these high initial costs to the point where the average person, not just the well-off, can afford to own. This is why these benefits are cherished by so many Americans. While a great deal has changed since the late 1700's and early 1800's, peoples' reasons for buying whole life insurance have not. Historically, appreciation in the value of whole life (inside build-up), which is merely a by-product of the level premium concept, has never been taxed unless the policy is surrendered, just as appreciation in the value of a home is not taxed unless and until the home is sold (with an exclusion for those over age 55).

˘ Taxing inside build-up would be a radical departure from long-standing tax policy which recognizes taxable income only in the event of actual or constructive receipt. Unlike the owner of a savings account, for example, a policyholder cannot withdraw money from the value of the policy to pay taxes owed on the appreciation without surrendering a portion of the policy and thereby destroying the purpose for which the policy was purchased in the first place. Unlike debt instruments, surrendered life insurance cannot be replaced unless the policyholder is insurable, and willing to pay a higher price due to older age.

TAXING INSIDE BUILD-UP WOULD BE UNSOUND SOCIAL AND ECONOMIC POLICY.

˘ Far from achieving simplicity, such a tax would be extremely complex and expensive to administer. Life insurance companies would be burdened with the time-consuming task of identifying, calculating and reporting to taxpayers and the IRS on the annual taxable increases in cash values of over 50 million policies. Taxpayers, in turn, would have to take these amounts into account when filing their returns. When the time came for them to file, it is likely that many of these taxpayers would not understand what causes them to have this phantom income, and why they should pay taxes on it. Being taxed on income over which they have no control and no constructive receipt is difficult enough to fathom without also having to understand the concept of imputing a value for term insurance and having that value increase the amounts exposed to tax. It would be the equivalent of imputing the value of rent on taxpayers' own homes as taxable income to them, a revolutionary idea and, we suggest, a politically unacceptable one.

During its consideration of life insurance tax reform last year, Congress reaffirmed the 1972 conclusion of the Joint Economic Committee that taxing inside build-up would be administratively infeasible. The idea remains unworkable and complex this year: there is no justification for revisiting it.

- Taxing inside build-up would result in long-range hidden costs as many current and prospective policyholders may be forced to either surrender their policies, buy less insurance than they need, or not purchase whole life insurance at all. Increasing costs to individuals and businesses would most likely result in cutbacks of coverage by those who have the least financial security as it is, and could least afford the consequences of inadequate protection. Demands would ultimately be placed on social service and welfare programs of the federal government and on Social Security to provide what individuals have heretofore been able to provide for themselves.

° Taxing inside build-up would be particularly burdensome to the aged because, if they maintained their whole life policies, their taxes would increase dramatically after they have retired even though they are earning less. This occurs because whole life policies are structured so that their cash value increases most rapidly after age 60 so that premiums can stay level. The imputed value of term coverage also escalates rapidly after age 60, which, under the Administration's proposal, would depress the basis in the life insurance contract and add to taxable income. Consider the following illustration. A 35 year old male in the 35 percent bracket buys a $50,000 whole life policy (his only insurance) with annual premiums of $502. The inside build-up in this policy increases at the rate of 7 1/2% per year. Ten years later, the policyholder has the option of stopping premium payments, since the $50,000 death benefit can be covered by the inside build-up, or continuing to pay premiums and increasing the death benefit. Because he has had another child since the policy was first purchased, and the value of the original face amount has been eroded by inflation, the policyholder decides to increase the death benefit by an amount which he considers prudent. In this case, the death benefit is allowed to reach $100,000 after 45 years. Under the Administration proposal this policyholder would have to pay more than $28,000 in taxes by age 75 in addition to premiums. This policyholder's insurance-related taxes for the decade beginning at age 60 would exceed $500 per year, at age 70 would exceed $800, at age 75 would exceed $1,200, and at age 80 would exceed $1,500, even taking into account a drop to the 25 percent tax bracket at age 65. Faced with such a situation, most people, we believe, would surrender their insurance policies.

Thus, at the very point in peoples' lives when they most need the insurance for which they have been paying for over 30 years, the Administration proposal would effectively tax it out of existence.

POLICY-NON-SMOKER-$50,000-MALE-AGE 35

Annual Premium $500.00

DURATION	ATTAINED AGE	IMPUTED COST OF INSURANCE PROTECTION FOR THE YEAR	YEARLY CASH VALUE INSIDE BUILD-UP TAX
5	40	199	56
10	45	266	133
15	50	357	240
20	55	466	384
25	60	601	573
30	65	986	618
35	70	1541	889
40	75	2306	1222
45	80	3321	1503

Taxing inside build-up would virtually eliminate the life insurance industry's ability to contribute to capital formation. Having sacrificed both equity and simplicity, enactment of these proposals would also deter economic growth. In addition to providing a pillar of economic security to many millions of average American families, the assets which build up in whole life policies are a major source of capital formation in our national economy. In 1983, the life insurance industry had assets of over $650 billion invested in U.S. capital markets. Of this amount, $76.6 million is in U.S. securities. Other industry investments are in corporate stocks and bonds, public utility and railroad bonds, etc. The proposals to tax inside build-up, by forcing people into term insurance, would dry up this major source of capital.

LOAN INTEREST DEDUCTIBILITY

Deductibility of interest paid on life insurance loans would be restricted under the Administration's general consumer loan interest deductibility provisions. These provisions would limit personal loan interest deductions to $5,000 in excess of total investment income (in addition to interest paid on primary residence mortgages). For instance, if an individual had $10,000 in investment income and $12,000 in total loan interest payments from all sources (other than home mortgages), all interest payments would be deductible. If the same person had no investment income, but the same amount of loan interest payments, only $5,000 of the interest payments would be deductible.

WE BELIEVE THAT THE RESTRICTIONS ON THE DEDUCTIBILITY OF PERSONAL BORROWING PROPOSED BY THE ADMINISTRATION, INCLUDING THOSE ON LIFE INSURANCE, WOULD SERVE NO USEFUL PURPOSE AND SHOULD BE DROPPED.

- As long as full interest deductibility is permitted for any kind of borrowing (i.e., mortgages, business loans), taxpayers will restructure their loans to take advantage of safe harbors. The end result will simply be disintermediation without any net change in consumption versus savings. If the purpose in limiting loan interest deductibility is to reduce consumption and encourage savings, the Administration's provision will not achieve it. Further, as a matter of sound social policy, interest paid on loans secured by life insurance should be deductible as long as any interest on any kind of loan is deductible. All the tax reform plans retain the deductibility of home mortgage interest because there is a strong consensus among members of Congress and the Administration that home ownership by as many people as possible is desirable from the individual's standpoint and is also in the best interest of our country as a whole. We believe that ownership of whole life insurance, to provide for survivors at the time of the breadwinner's death is both socially and economically an equally desirable goal, and should be similarly encouraged.

- The ability to deduct loan interest makes it possible for people to meet financial emergencies without surrendering their assets, including life insurance policies. The flexibility provided whole life policyholders by the borrowing feature has proven invaluable to millions of Americans in two ways. First, by relieving the anxiety that the average person tends to have about making long-term financial commitments which entail fixed obligations for years to come, the option to borrow if necessary encourages people to obtain the protection they need. Second, the ability to borrow in the event of financial emergency enables policyholders to keep their insurance in force rather than surrender it to obtain badly needed cash.

Under current law, the option to borrow against a life insurance policy should not be confused with actual behavior. While the ability to borrow against a policy should it become necessary encourages people to purchase whole life rather than term despite whole life's initially greater expense, this capability is used rarely and generally as a last resort. Industry-wide policy loan activity figures bear this out. Even over the past ten years, which included periods of poor economic conditions, high interest rates, and high unemployment, the rate of borrowing on policies in force remained stable at about 28 per cent. Most of these loans are one-time responses to specific situational needs for cash. Thus, once a whole life policy has been purchased, most people do not deplete its value through borrowing. While this policyholder option is not used excessively, it has great utility, both as a means of encouraging people to purchase the whole life insurance they need, and as a valuable right for those who may, in emergencies, need to use it.

CONCLUSION

In light of all these considerations, we sincerely believe that the public interest would not be served by any of the tax reform and simplification proposals relating to life insurance.

When the Treasury Department's original tax reform proposal was first released last November, then-Secretary Regan noted that, under it, there would be winners and there would be losers. This is at least as true for "Treasury II". If the Administration's provisions affecting the taxation of life insurance are adopted, many current owners and every prospective owner of a whole life policy, as well as all of their beneficiaries, would be among the losers. These are the very people who, according to a January Washington Post/ABC News poll, liked the idea of the Treasury's income tax simplification and revision plan. However, the poll results also indicated that a great deal of this support came from people who had little or no understanding of the plan, except that it was supposed to close the loopholes which benefit big companies and wealthy individuals to the detriment of everybody else.

Many of them were later surprised to discover that, among other things, their personal life insurance had been lumped into this category. A July 4 poll by the same organization shows that there has been a substantial erosion of support as the middle class has correctly perceived that they will benefit the least of any income group under the Administration plan. This is so because most of the reasonable incentives that have encouraged average people to provide for themselves (such as life insurance), would be eliminated, while the wealthy would reap the major benefits of rate cuts. This is not what tax reform should be about, and such an approach will not achieve the broad middle class support that is essential for its enactment.

The Administration's new tax proposals relating to life insurance products and companies achieve none of their stated goals: they are not fair, they are not simple, and they will thwart economic growth. Indeed, since the announcement of the first Treasury plan in November, 1984, the market for insurance products has been severely damaged as many pending purchases have fallen through, and, on others, payments have been withheld pending final Congressional action. The long-range nature of the financial commitment needed to sustain whole life insurance policies makes them extremely vulnerable to this kind of uncertainty. Last year, after more than two years of study and debate, Congress' enactment of major life insurance tax reform provisions included for the first time a definition of life insurance, thereby eliminating the potential for abuse of life insurance by individuals looking for investments with shelter advantages. Further changes are unnecessary and will, if enacted, severely, if not irreparably, damage an otherwise healthy industry, and undermine the financial security of millions of American families.

STATEMENT OF EDWARD E. PHILLIPS, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, NEW ENGLAND MUTUAL LIFE INSURANCE CO., BOSTON, MA, AND CHAIRMAN OF THE BOARD, AMERICAN COUNCIL OF LIFE INSURANCE

The CHAIRMAN. Mr. Edward Phillips.

Mr. PHILLIPS. Thank you, Mr. Chairman.

I am Edward Phillips, chairman of the board and CEO of New England Mutual Life Insurance Co. of Boston; and also currently chairman of the board of the American Council of Life Insurance, ACLI, for whom I appear today.

The ACLI has 627 member life insurance companies who write about 95 percent of the life insurance written in the United States. We are also very concerned, Mr. Chairman, about the consequences of the proposed tax increases on life insurance companies and on individual policyholders.

If enacted, the life insurance industry would be impacted severely, and the financial security of millions of Americans would be threatened.

My prepared statement discusses these issues in much greater detail, and I would respectfully request that it be included in the record.

The CHAIRMAN. All the statements will be in the record.

Mr. PHILLIPS. Thank you, sir.

In general, the tax treatment of life insurance companies and policyholders, as the two previous witnesses have outlined, was scrutinized closely by the Congress during the last 4 years, and very extensive changes were enacted only last year in 1984. Now only a few months later the administration has proposed still another set of major tax changes for our business.

Many of these proposals were considered and rejected by the Congress in developing the 1984 bill. Others were addressed, but in a very different manner than now proposed. In all cases, the administration actively participated.

Mr. Chairman, we have great trouble understanding why the administration now would walk away from the comprehensive legislation it took part in which resolved these difficult issues just last year.

Specifically and notably, the administration proposes to tax the inside buildup in cash value life insurance and annuity contracts. And without getting into any detail, because two previous witnesses have covered it I think beautifully, to support the proposal the administration compares cash value life insurance to an investment, such as a certificate of deposit where interest is not received until maturity or an investment in a mutual fund. Such comparisons simply do not stand up. The purpose of growing cash values is to enable insurance companies to provide lifetime protection at a level premium. A policyholder does not have access to cash value funds except by borrowing and paying interest on that loan, just as interest will be paid on a bank loan; or by surrendering and canceling a life insurance policy and paying any taxes then due.

We are, of course, pleased that the staff of the Joint Committee on Taxation in its recent document prepared for the Ways and Means Committee markup has now suggested simply retaining present law regarding taxation of life insurance. For most of the same reasons, the proposed new tax should also be dropped in the case of annuities.

Now let me turn briefly, if I may, to two sets of administration proposals that would impact directly on life insurance company taxes. The first would severely limit reserve deductions. The second would eliminate the special deduction and the provision for small companies enacted just last year by the Congress. We strongly urge that both be rejected.

The administration defends its proposal on life insurance reserves with the argument that current taxes are based upon minimum levels of reserves which are overly conservative. The premise is simply wrong. The life insurance reserve deduction rules were thoroughly reviewed and significantly tightened in the 1984 legislation, and under the new rules, tax reserves are based on the minimum reserve levels established in a majority of the States. It's hard to understand why after only a few months the Treasury now thinks these rules are outmoded.

Again, we are delighted the staff of the Joint Taxation Committee now suggests we leave the present reserve rules in tact.

The special and the small company deductions were also an integral part of the comprehensive revision enacted in 1984. Their repeal would do violence to the balance which was then struck. The 20-percent special deduction for all companies, the so-called TIA, was introduced into a complex tax formula in order to achieve the appropriate agreed-upon level of tax revenues for life insurance companies relative to other financial institutions and industries. The deduction for small companies was introduced to provide equity and encourage competition in the industry. And these provisions should not be swept blindly away under the label of tax reform.

Another issue we thought had been laid to rest last year and then again this year as a result of the administration's review of Treasury's proposals is the tax treatment of policyholder loans. But the Joint Taxation Committee staff has again reopened the matter by suggesting no deduction be allowed for interest on such loans and that the amount of any such loans above a specified amount be treated as taxable events. We strongly oppose such recommendations.

I will eliminate the couple of paragraphs I have in support of that statement, Mr. Chairman, as my time is running out, and I know that the representatives from the agent's associations as well as the two previous witnesses will go into that in some detail.

To conclude, I would note we are very concerned with the administration's employes benefit plan proposals, and have commented on them in detail in a statement previously filed with your committee. Since the time our statement was filed, the administration has proposed as a revenue measure a complete repeal of the provisions allowing for the establishment of section 401(k) retirement plans, and the Joint Committee staff has also resurrected the Treasury's original proposal to tax the first $50,000 of group life insurance, which was eliminated from the administration plan. Both of these we strongly continue to oppose.

Thank you very much for the opportunity to present the views of the American Council, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

[The prepared written statement of Mr. Edward Phillips follows:]

STATEMENT OF
THE AMERICAN COUNCIL OF LIFE INSURANCE

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is Edward E. Phillips. I am Chairman of the Board and Chief Executive Officer of New England Mutual Life Insurance Company and am appearing today on behalf of the American Council of Life Insurance ("ACLI") of which I am the current Chairman.

The ACLI has 627 member life insurance companies who have approximately 95 percent of the life insurance in force in the United States and hold 93 percent of the assets of all United States life insurance companies.

INTRODUCTION

Mr. Chairman, we are grateful that you and the members of this Committee are holding hearings to look into the impact that the Administration's tax proposals would have on various industries and their customers.

We are gravely concerned about the consequences of proposed tax increases on (1) the life and health insurance business; and (2) individuals who purchase life insurance policies and annuities. Our statement today will detail these concerns.

As this Committee is well aware, the tax treatment for life insurance companies and their customers has been closely scrutinized by Congress during the last four years, with very extensive changes enacted last year as part of the Deficit Reduction Act of 1984 ("DEFRA"). These changes were in addition to those enacted a mere two years earlier as part of the Tax Equity and Fiscal Responsibility Act ("TEFRA"). Now, within a few months of the passage of the most recent legislation, the Administration proposes still another set of major changes in the treatment of life insurance companies and their policyholders. Many of these proposals had been considered and rejected by Congress during the development of DEFRA and TEFRA. Others were addressed, but in a different manner than now proposed. In all cases, the Administration actively participated in the debate of the issues. In light of this, we see little justification for the Administration's proposal to re-visit what Congress and our business had thought was resolved.

Moreover, the tax uncertainties thus created have had, and are having, an adverse impact on our markets because they cause customers to defer taking action.

Individually purchased annuities and life insurance presently provide essential financial protection and security to many millions of individuals. In 1983, for example, $7 billion was paid in permanent life insurance death benefits. These products also perform the extremely important function of facilitating the accumulation of capital, which is necessary for a dynamic economy, higher income levels and expanding employment. To date, permanent life insurance has provided about $150 billion in long-term funds for investment in the U.S. economy.

For almost half a century, Congress has encouraged the purchase of individual life insurance and annuities. Support for these private sector efforts has been reflected in the tax treatment provided by current law. The provision and expansion of these inherently desirable forms of protection should be fostered and not discouraged. Yet the Administration's proposals risk impairing the development of these essential protections.

In support of these drastic changes, the Administration argues that, if its recommendations were enacted, the tax laws could be simplified and tax rates could be reduced. In fact, the Administration proposals complicate the taxation of insurance and increase taxes on insurance products so important for financial security. These changes reverse long-standing policies to encourage the growth of private risk protection, would ultimately lead to less private insurance coverage, and would undoubtedly result in a demand for increased federal expenditures to take up the resultant slack of protection against economic uncertainty.

The balance of our statement will discuss in detail each of the Administration's proposals to increase the taxes on the life insurance industry and its customers. We wish to stress at the outset, however, that we are also very concerned with the many proposals in the Administration's program that would impact on employee benefit plans. We have previously submitted a comprehensive written statement on these proposals to your Committee for inclusion in the record of your July 19 hearings on employee benefits and therefore will not -- with one exception -- address benefit issues in this statement. The only benefit issue that will be addressed involves an Administration proposal that was not advanced as of the July 19 hearings -- that is, the proposed complete elimination of Section 401(k) plans.

SPECIFIC COMMENTS

I. PROPOSED TAX INCREASES ON LIFE INSURANCE COMPANIES

The Administration's proposals would increase taxes on life insurance companies in three areas. First, the proposals would limit the deduction companies could take for increases in reserves (liabilities) to increases in cash values -- even for contracts that have no cash values -- and would cut back deductions for accident and health insurance reserves which do not qualify as life reserves. Second, the proposals would eliminate the special deduction for life insurance companies, enacted last year as part of the revisions of the life insurance company tax act. Finally, the Administration's proposals would repeal the provisions for small companies enacted as part of the same law. The ACLI is opposed to all of the Administration's proposals.

A. PROPOSED CUTBACKS IN RESERVE DEDUCTIONS

The Administration would significantly reduce or eliminate the deductions a life insurance company may take for (1) life insurance reserves and (2) for accident and health insurance reserves which do not qualify as life insurance reserves. These proposals are completely at odds with fundamental insurance and accounting concepts and would produce tax increases that can only be explained as an attempt to tax policyholders indirectly on amounts earned on insurance company reserves.

Life Insurance Reserve Deduction

Under current law, life insurance companies are allowed a deduction from taxable income for amounts they add during a taxable year to life insurance reserves. The life insurance reserve for a contract is the greater of (1) a reserve for the contract liabilities determined under a prescribed set of actuarial rules (based on prevailing minimum state regulatory requirements) relating to reserve method, assumed interest rate and assumed mortality or morbidity rate; or (2) the net cash value of the contract. This definition of tax reserves was adopted in 1984 and represents a substantial tightening of the reserve deduction provisions over those previously in effect.

The Administration proposes that, for purposes of computing the reserve tax deduction, the life insurance reserve for any contract would be limited to the net cash surrender value of the contract (taking into account any surrender penalty or charge). The Administration indicates that a special rule would be provided for immediate annuity contracts that may not be surrendered for cash, although it gives no indication of how this rule would operate. The effect of the proposal would be to reduce or eliminate reserve deductions for the early years of ordinary life insurance contracts and to deny any reserve deductions for most policies of term and group insurance and for many supplemental benefits.

Why the Proposal Should be Rejected

1. The Administration's assertion that current tax reserve levels are too high is directly at odds with the action taken by Congress in 1984 to update the reserve provisions.

A major premise for the Administration's proposal is that the current levels of life insurance tax reserves are overly conservative (too high). This is wrong. In 1984, as part of the Deficit Reduction Act, Congress carefully reviewed and substantially revised the tax rules governing reserves of life insurance companies. The new rules are far more stringent than the prior ones and assure that tax reserves will be lean. Under the new law, to be recognized for tax purposes, reserves must not exceed the minimum levels required by the laws of a majority of the states. In this regard, the new rules mandate the use of the Commissioner's Reserve Valuation Method for calculating tax reserves. This method produces reserves in early years substantially lower than the net level method which had been permitted under prior law.

In addition, the new rules require the use of interest rates and mortality standards which are consistent with contemporary conditions. The 1980 Commissioners Standard Ordinary Table is the prevailing mortality table. The interest rates are automatically updated each year according to an index keyed to the Moody's Corporate Bond Yield Averages -- Monthly Average Corporates. All of these changes have resulted in recognition of significantly lower reserves for tax purposes than under prior law. They were made only after extensive consideration by Congressional staff and the Treasury.

Treasury's assertion that present reserve levels are overly conservative is clearly inconsistent with these actions taken by Congress last year. In fact, the debate within the industry now is not about whether state reserve minimums (on which tax reserves must be based) are too high but rather whether or not they are sufficient. In this regard, the National Association of Insurance Commissioners, at its March 1985 meeting, authorized the establishment of a special task force to suggest an approach that can be used by regulators of individual states to address these concerns.

Finally, the 1984 reserve changes represented but one of a number of related changes in the framework for taxing life insurance companies. A radical change in the reserve provision would upset the balances established by these changes in tax revenues and product costs. In view of this very recent legislative action, it is clear that the Administration's proposal is both ill-timed and unnecessary.

2. The Administration's proposal adopts a monetary measure of life insurance reserves that has absolutely no accounting or actuarial basis. It would tax a life insurance company on income that is unrelated to its economic gains.

In exchange for a premium, a life insurance company assumes an obligation to pay a specified amount to a policyholder on the occurrence of a specified event such as death, survival or disability. The company should receive a tax deduction equal to the value of this obligation at the time it is assumed i.e., when the premium is received. A life insurance reserve is the monetary measure of such an obligation. If a deduction for this reserve is not allowed, the result is a current tax on gross premiums, rather than on net income (Revenue Ruling 80-222, 1980-2 CB 211).

The Administration says that it recognizes the appropriateness of allowing a tax deduction for life insurance reserves. ("Thus, if gross premiums are included in the gross income of the company, an offsetting deduction for the savings (reserve) component of the premium is appropriate.", The President's Tax Proposals, p. 261.) However, once having acknowledged the need for a reserve deduction, the proposal proceeds to adopt a monetary definition of what constitutes a life insurance reserve which has absolutely no accounting or actuarial basis, and which, in many cases, will result in no reserve deduction whatsoever:

(a) For contracts with cash values, the Administration's proposal would look to these values as the proper measure of the tax reserves. This approach is fundamentally flawed from an actuarial standpoint. The cash value of a policy serves a different purpose than the reserves. And, particularly in the early years of a policy, is not the financial equivalent. As Professor Dan McGill of the Wharton School states in his textbook, Life Insurance, p. 299, "While both of these values (reserves and cash values) arise out of the leveling of premiums, they have no other connection and serve quite different purposes."

As discussed above, the reserve for a policy is the monetary measure of all of the life insurance company's obligations under the policy. The cash value is the amount, if any, that will be paid to the policyholder as an equitable settlement if he or she surrenders the policy before the insured event. Some policies contain no surrender value and the company need reserve only for the insurance obligation. Other policies contain a net surrender value larger than the present value of the insurance obligation and the company must reserve for the higher surrender value.

The basic flaws in the Administration's proposal are most apparent in the early years of a policy where the proposal would produce reserve tax deductions that are completely unrelated to the company's obligations and which will vary from policy to policy. Consider, for example, two policies identical in all respects except for the pattern of early cash values. Assume the cash values are identical at policy year five and thereafter. However, the first policy gives no cash values until the end of the fifth policy year, while the second provides early cash values smoothly grading into the fifth year value.

The Administration would require, with respect to the first contract, that all premiums be included in income with no deduction for reserves until year five, while the second contract's surrender values would generate at least some current reserve deductions. Such a result has no rational basis and would seriously distort the design of life insurance products, and hinder the free operation of the insurance market. Moreover, in early policy years, it could impose a prohibitive cash penalty (in the form of tax payments on gross receipts) on companies entering, or growing rapidly, in a line of business.

(b) For contracts without cash values, the Administration's proposal completely ignores reserve obligations. A deduction would be allowed only for the claim payments when made. For these contracts, life insurance companies would be forced to a cash basis of accounting.

Elsewhere in its program, the Administration strongly argues that the cash method of accounting is generally inappropriate:

> The cash method of accounting frequently fails to reflect the economic results of a taxpayer's business over a taxable year. The cash method simply reflects actual cash receipts and disbursements, which need not be related to economic income. Obligations to pay and rights to receive payment are disregarded under the cash method, even though they directly bear on whether the business has generated an economic profit or a loss. Because of its inadequacies, the cash method

> of accounting is not considered to be in accord with generally accepted accounting principles and, therefore, is not permissible for financial accounting purposes. ("The President's Tax Proposals", p. 213.)

This analysis is particularly true for life insurance companies where current premiums trigger long-term liabilities. Unless these liabilities may be matched against the related premiums, the company's taxable income will not in any sense be a measure of its economic income.

The National Association of Insurance Commissioners, agrees with this analysis as to the inappropriateness of using cash value as a measure of tax reserves. In its testimony before the House Ways and Means Committee on July 19, 1985, it opposed the Administration's proposal to use cash values as a measure of tax reserves. It stated that "The current proposal to limit life insurers' reserves to cash surrender value equivalents is even less conservative (than current law) and, as such, is a disincentive for maintaining adequate reserves."

3. The Administration's proposal would produce harsh and irrational results that would be extremely costly to policyholders.

The result of disallowing any life insurance reserve deduction, or providing a deduction that is too low, would be irrationally harsh. In the absence of an appropriate reserve deduction, a life insurance company would have to use its surplus to pay current taxes on premium and investment income that are required to be set aside in reserves. Providing for a return on this equity would raise premiums on most coverages -- in effect, a hidden tax on policyholders. Several coverages would be difficult, if not impossible, to write at the higher premium level.

Annuity contracts which provide for an immediate annuity clearly illustrate the problems. These contracts generally have no cash surrender values. Consider, for example, such an annuity contract with a $10,000 premium, no net surrender value, and annuity payments beginning immediately. Without a deduction for the related reserve, a tax under the Administration's program of 33 percent of the premium received, or $3,300, would be currently payable. This tax would only be recouped as deductions were later taken by the company for the annuity payments. The result is that the company must use surplus to pay the taxes. This would dramatically increase the costs of such contracts as well as put a strain on the company's surplus. Sales of the product, even if they could be made at the higher premium, would probably be sharply curtailed because of the company's surplus needs. The Administration's proposal recognizes these potentially serious problems, and would allow a reserve deduction.

However, the proposal does not recognize similar problems for the many other types of products that have no cash values and, thus, would be allowed no tax reserves. These include deferred annuities used to fund benefits under terminated pension plans, as well as non-cancellable and guaranteed renewable accident and health insurance which develops significant reserves for future obligations without surrender values. Also severely affected would be non-cancellable group life coverages on disabled lives, both permanent and term.

In conclusion, the Administration's proposal to limit the life insurance reserve deduction to the increase in cash values fails to recognize the insurer's obligation to set aside reserves for future insurance payments. It should be rejected.

Accident and Health Insurance Reserves--Unpaid Loss and Unearned Premium Reserves Deduction (Qualified Reserve Account)

Under current law, a life insurance company includes premiums on accident and health insurance in taxable income as they are earned over the terms of the policies. In the case of claim payments which are to be made after the close of the taxable year in which the premium is earned, a deduction is taken through a mechanism of reserving for these payments (whether or not the losses have been reported during the year). For long-term disability policies (which produce the bulk of the unpaid losses of life insurance companies under accident and health insurance policies which would be subject to the QRA proposal), the reserves are generally computed in essentially the same manner as life insurance reserves, that is, on the basis of mortality and morbidity tables and discounted at assumed rates of interest.

Under the Administration proposal, a life insurance company apparently would have to compute the deduction with respect to its non-life insurance reserves under the Qualified Reserve Account ("QRA") method proposed generally for property and casualty insurance companies. Under this method, a life insurance company would establish tax reserve accounts for claims to be paid in an amount estimated by the company to be sufficient to fund payment of the claims, taking into account the company's estimates of the amount of the claims, the time of payment of the claims, and the company's actual after-tax rate of return on its assets. Alternatively, it could establish a QRA equal to the full Annual Statement reserve. Separate tax reserve accounts would have to be established by line of business and by year of policy issuance. These accounts would replace both the unearned premium reserve and the unpaid loss reserve under current law.

Each account would be required to be increased annually by an investment income increment computed by using the company's actual after-tax rate of return on surplus and reserves. However, contrary to long-standing tax principles, no deduction would be allowed for the investment income added to the QRA account, although the full reserve (including this income) would be released into taxable income when a claim payment is made or after a maximum period of years.

In advancing QRA, the Administration criticizes the present tax treatment of loss reserves of property and casualty insurance companies. It notes that, in general, these reserves are "not discounted" and that the "current treatment of P & C insurance reserves distorts the choice between self insurance and third party insurance." The President's Tax Proposals, p. 226-227.) Then, in almost a passing reference and without any further explanation, the Administration indicates that its proposal would extend to reserves for unpaid losses held by life insurance companies (The President's Tax Proposals, p. 269.)

As we will show, there are compelling reasons why QRA should not be applied to reserves whether they are held by property and casualty companies or life insurance companies. Preliminarily, however, it should be noted that the reasons cited by the Administration for advancing QRA particularly ignore the situation of life insurance companies.

In particular, the bulk of the accident and health insurance reserves at issue for life insurance companies are held under long-term disability policies and are computed on a discounted basis.

Additionally, and contrary to the impression given by the Administration, self-insurance is not the usual alternative to insurance in the case of long-term disability plans. Rather, employers choosing not to purchase coverages from an insurance company generally use a tax-exempt trust (i.e., a Section 501(c)(9) trust) to fund the plan. In this situation, unlike the QRA approach, contributions, within limits, are not taxed to the trust and there is no tax on the interest.

Finally, life insurance companies are currently allowed only a prorated exemption for their tax-exempt interest. The QRA proposal has its own proration mechanism. If QRA is applied to life insurance companies, there would be a double proration.

Why the Proposal Should be Rejected

1. **The QRA proposal would place a life insurance company on an equivalent of a cash basis of accounting with respect to its accident and health business. Cash accounting for this business would grossly distort a company's tax base. Such an accounting basis has generally been rejected by the Administration.**

The Administration agrees that its QRA proposal would place a life insurance company on an equivalent of a cash basis of accounting with respect to its accident and health business. Especially in the case of long-term liabilities of the type assumed by life insurance companies, a cash accounting system grossly mismatches income and expenses. In fact, elsewhere in its proposals, the Administration concedes that the cash basis is generally inappropriate for business taxpayers, other than certain small businesses, in that it fails to reflect the economic results of a taxpayer's business over a taxable year.

The National Association of Insurance Commissioners expressed the same concern in different words: "The effect of the QRA approach is to tax a portion of the accumulated reserves that are necessary to meet contractual obligations to policyholders. The QRA method is a subtle device to tax policyholder reserves for amounts that have not and will not inure to the insurer." (Testimony before House Ways and Means Committee, July 19, 1985.)

2. **The QRA proposal includes in taxable income an amount that is greater than the company's economic gain.**

The method used in this instance to accomplish a cash basis result (i.e., QRA) is to allow a reserve deduction, but then to subsequently tax more income than is actually realized by the company.

To be more specific, consider an insurance company which receives a $100 premium net of expenses and pays a $100 claim out of that premium one year later. Its sole profit arises from, say, $12 of investment income earned on the asset over the year. Under the QRA proposal, the company may set aside the $100 in a claim reserve in the first year and must add $8 of after-tax investment income to the reserve (assuming a 33 percent corporate tax rate). No deduction is allowed for the $8 added to the reserve; but when the $100 claim is paid, the company must bring the entire $108 reserve into income. This triggers an additional $8 of taxable income at the time the claim is paid. The company is thus taxed on $20 ($12 investment income plus $8 of reserve release income). The company's taxable income of $20 is 1.7 times its pre-tax income of $12.

In effect, the QRA taxes a company on more than its economic income. This additional tax at the company level can reasonably be viewed as a proxy tax on behalf of the policyholders.

3. The QRA proposal will increase the cost of insured accident and health coverage, particularly for long-term disability benefits. This would be a disincentive to use insurance. A move away from insured coverage poses a genuine threat to the security of those becoming disabled.

The additional QRA tax would increase premiums for insured coverage. This tax would be particularly large for coverages whose claims take a long time to run off, such as disability income. For example, it is estimated that the QRA proposal will increase the cost of insured long-term disability coverage by about 10 percent. Such a sharp increase in premiums will drive many employers to uninsured arrangements. In this regard, it should be noted that the differential of only 2 percent due to state premium taxes has been a significant factor causing many major employers to adopt non-insured plans.

A non-insured plan reduces the financial security of the employees and their dependents significantly. In the event of bankruptcy, medical claims have no priority over other claims against the employer. In contrast, insured claims will be paid through State Guaranty Funds even if an insurer goes bankrupt.

4. Implementing the QRA proposal would be an administrative nightmare. This is contrary to the Administration's expressed purpose of simplifying tax calculations.

The QRA proposal requires that separate reserve accounts be set up based on policy issue year and type of coverage; that these reserves include both unearned premium reserves and unpaid losses; that "after-tax" interest be allocated to each of these reserve accounts; that resultant claim runoff be charged against each of these reserve accounts; and that a "final accounting" be done for each of these reserve accounts to close them out for purposes of tax computation.

Some of the problems with doing all this are as follows:

- there would be an enormous number of accounts to deal with, as companies have literally scores of issue years, and for each issue year there can be many claim incurral years;
- companies do not currently aggregate claim reserves by issue year, and may not even have issue year information that is readily available;
- claims and expenses incurred in the early part of a new year but covered by the previous year-end claim reserve may need to be separately identified and charged back to the previous year's QRA;
- aggregate reserves currently held for multiple coverages under the same contract (e.g., unearned premium reserves) would have to be arbitrarily split apart to be allocated to the appropriate QRAs;
- companies would have to make fundamental systems changes to allocate investment income to each QRA, and to do "final accountings".

In sum, Qualified Reserve Accounting would place a life insurance company's accident and health business on the equivalent of a cash basis of accounting under a mechanism that taxes a company on more income than it realizes. Such a tax accounting basis is clearly inappropriate. It would result in an indirect tax on policyholders that would create a disincentive to insurance. The QRA should be rejected.

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In conclusion, we believe both the Administration reserve proposals should be rejected. As stated in a recent report prepared by Ernst & Whinney, "the President's tax proposals would not appropriately match revenue and expense nor measure economic income....for these reasons, the proposals should not be enacted." A copy of this report, entitled "A Review of Life Insurance Company Reserve Proposals in the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity" is attached.

B. REPEAL OF THE SPECIAL LIFE INSURANCE COMPANY DEDUCTIONS

A life insurance company is allowed a special deduction in an amount equal to 20 percent of its adjusted taxable income. This deduction applies only with respect to income resulting from a company's life insurance business, so gains and losses arising from a non-insurance business operated by a life insurance company will neither increase nor decrease the amount of a company's special life insurance company deduction. In addition, a small life insurance company is allowed a deduction equal to 60 percent of the first $3 million of its adjusted taxable income. This deduction phases out as that income increases from $3 million to $15 million. The small company deduction is allowed only to companies with gross assets of less than $500 million.

The Administration's proposal would repeal the life insurance company special deductions. The proposal recognizes that the special deduction related to taxable income was intended to reduce the competitive impact of the new life insurance tax rules which broadened the tax base of life insurance companies without similarly broadening the tax base for competing financial institutions. However, according to the Administration, its overall program eliminates any further need for the special deduction because its proposals sufficiently broaden the tax base of other financial institutions and reduce the maximum marginal rate applicable to all corporations. The Administration also argues that after comprehensive tax reform, special rules for small life insurance companies would no longer be appropriate.

Why the Proposal Should be Rejected

1. The special taxable income deduction for life insurance companies is an integral part of the comprehensive revision and simplification of the system for taxing life insurance companies enacted less than a year ago. Repeal of this provision alone would do violence to the delicate balance effected by the entire comprehensive structure developed in 1984. Significant modification of the new law would be premature at this time before the new method for taxing life insurance companies is given a chance to work and its effectiveness can be evaluated.

The special deduction for life insurance companies was enacted in 1984 as part of the first comprehensive revision of the federal income tax provisions for taxation of life insurance companies since 1959. The essence of the provisions of the Code dealing with life insurance companies is to define the base on which they are taxed. That base was substantially broadened in the 1984 provisions.

The new life insurance company tax provisions represent the culmination of several years of study and consideration of the appropriate framework for taxing life insurance company income, and these provisions must be viewed as a whole. This new law is an integrated package of provisions intended to simplify the prior law's complexities while maintaining the delicate balance between stock and mutual life insurance companies as well as competitive parity between all life insurers and other financial services institutions. Each provision of the package, including the special deduction, is essential to the achievement of these goals. It is therefore inappropriate to consider, in isolation, the merits of one of these central provisions, the special deduction, even though the high visibility and easy comprehension of this provision may seem to invite such individual consideration.

In this regard, there was much debate over the appropriate percentage for the special deduction, and Congress included a provision requiring the Treasury to study annually the effects of the new law on the industry's relative tax burden beginning in July of 1985. For most companies, the first tax returns under the new law will not even be filed until September 1985. Accordingly, it is too soon to determine the actual effective tax rates companies will experience under the new law. Many life insurance companies believe that even with the special deduction, their effective tax rate will be significantly higher than under prior law. Clearly, consideration of significant changes in the new system, such as the repeal of the special deduction, should be deferred until there has been an opportunity to evaluate several years of experience under the new law.

2. **The special deduction replaced a number of complex deductions life insurance companies were allowed under**

prior law which, among other things, recognized that the long-term nature of the life insurance business makes it difficult, if not impossible, to measure the economic income of life insurance companies on an annual basis. It is inappropriate to simply repeal the deduction without, in some other way, dealing with this issue.

One reason for the special deduction for life insurance companies was as a replacement for a number of complex deductions life insurance companies were allowed under prior law. For example, under prior law, a life insurance company was allowed to defer taxation on one-half of its underwriting gain, in recognition of the long-term nature of life insurance contracts and the difficulty of determining income over a short accounting period. Another of the deductions allowed to life insurers under prior law, a deduction for nonparticipating insurance, recognized the need for contingency reserves over the long run for this type of contract. Also under prior law, life insurance companies were allowed a special group insurance deduction (two percent of group insurance premiums), the purpose of which was to compensate for the fact that in group insurance there is more concentration of risk.

The authors of the 1984 provisions believed that these and other deductions under prior law added undue complexity to the system for taxing life insurers. Accordingly, they were repealed. However, the special deduction was enacted, partly as a replacement for these unique deductions. There is nothing in the Administration's comprehensive tax reform proposal that makes the special deduction any less important in this respect.

3. The special deduction for life insurance companies was enacted, in part, to recognize that life insurance companies would be placed, if taxed on their full income as measured under the 1984 rules, at a significant competitive disadvantage relative to banks, Blue Cross and Blue Shield organizations, self-insurance trusts, etc. This need for the special deduction would still largely exist even under the Administration's program.

A major impetus for inclusion of the life insurance company special deduction was to insure that life insurance companies could remain competitive with other tax-favored and tax-exempt financial intermediaries (e.g., banks, thrift institutions, self-insurance trusts, Blue Cross-Blue Shield, etc.). Congress believed that the special deduction was necessary because the new life insurance company tax provisions broadened the tax base for life insurers without enacting legislation that would similarly broaden the tax base for competing financial institutions. (See H. Rep. No. 98-432, 98th Cong., 1st Sess., Vol. 1, p. 111, 1983).

The Administration submits that its program would affect all financial institutions and would eliminate the justification for the special deduction for life insurance companies.

The Administration's proposal does not, however, achieve competitive equality for all institutions which sell insurance or provide financial services. Many of the most direct competitors of life insurance companies remain tax-exempt under the proposal. Blue Cross and Blue Shield organizations and self-insurance trusts, organizations which are exempt from federal tax under current law, compete with life insurance companies for group health insurance business. Since the Administration's proposal retains these tax exemptions, the repeal of the special deduction would give these tax-exempt organizations an even greater advantage than they now enjoy in competing for group health insurance business.

Furthermore, although the Administration's proposal does contain provisions which would repeal certain tax benefits and deductions enjoyed by banks, thrift institutions and similar organizations which compete with life insurance companies in the sale of financial services, it is by no means clear that the effect of the proposal, if enacted, will be competitive equality. Absent a much clearer definition of the proposed tax changes for these institutions, as well as extensive study of the impact these proposals would have on effective tax rates, there can be no assurance that the proposal accomplishes its goal of equal tax treatment for all businesses which sell insurance or provide financial services.

Finally, any study of competitive tax burdens is simply incomplete unless state and local tax burdens are included in the equation. Life insurers have traditionally paid a tax on gross premiums (whether there are earnings or not) to state and local governments. The "effective" tax rate on income represented by these taxes has been substantially greater than income tax rates or other taxes paid to states by competitor organizations.

Unless and until this overall, critical analysis proves otherwise, a special deduction for life insurers will remain appropriate.

4. The small life insurance company deduction was enacted in 1984 to prevent a dramatic increase in the tax burden of these companies compared to prior law. That justification still applies.

The Administration argues that after comprehensive tax reform, special rules for small life insurance companies would no longer be appropriate. Just last year Congress considered this matter, and recognizing that small life insurance companies had enjoyed tax-favored status for some time, declared it inappropriate to "dramatically", according to the March, 1984 report of the Ways and Means Committee, increase the tax burden of small companies. The Administration now proposes to more than double the effective rate of tax on the smallest life insurance companies by removing the small company deduction. Circumstances have not changed so much in so short a time as to call for such a dramatic increase now.

The small company deduction was instituted in 1984 as an important element of a complex package and it replaced (together with the special deduction already mentioned) a body of rules under the 1959 law. Those rules, as they applied to a small company, permitted the small company to compete, and to grow, within the life insurance industry. It was to permit the small companies to continue to compete and grow alongside the larger companies that the small life insurance company deduction was enacted in 1984. The Administration's proposal does not take account of this purpose, which still remains valid.

The proposal would also disregard another fundamental aspect of the carefully considered set of rules for life insurers embodied in the 1984 revision: the division of tax burdens between mutual and stock life insurance companies. This aspect of Congress's tax work in 1983 and 1984 was perhaps the most difficult task faced, and the mutual/stock "segment balance" compromise reached was both delicate and critical to the success of the recent legislation. While the small company deduction is available to small mutual companies, it was recognized to principally benefit small stock companies, and thus was a key factor in determining that segment balance. Repeal of this deduction would ignore that factor and change the balance so carefully worked out.

In conclusion, the special deduction for life insurance companies and the deduction for small life insurance companies, provisions thoroughly considered and enacted by Congress just last year, should be retained.

II. PROPOSED TAX INCREASES ON INDIVIDUAL CUSTOMERS

The Administration's tax proposals would increase taxes on individual customers of life insurance companies in several major respects. A new tax would be levied on the increase in the value of individual life insurance policies -- often referred to as the "inside buildup." A corresponding tax is proposed for owners of individual annuity contracts. In both cases, we will list some of the reasons why we object to the Administration's proposals.

A. PROPOSED TAXATION OF "INSIDE INTEREST BUILDUP" ON LIFE INSURANCE POLICIES

Under the Administration's proposal, life insurance policyholders would be required to include in interest income any increase during the taxable year in the amount by which the policy's cash surrender value exceeds the policyholder's basis in the contract. A policyholder's basis in the contract would be equal to the aggregate of the gross premiums paid for the policy, reduced by the aggregate policyholder dividends and other distributions received from the policy and by the aggregate cost of the insurance protection provided by the policy. In addition, a special rule would be provided to prevent a contractholder from being taxed on the unrealized appreciation of assets underlying a variable life insurance policy.

The proposal would be effective for all "inside buildup" credited on or after January 1, 1986, to policies issued on or after the date of adoption of the proposal by one of the tax-writing Committees of Congress.

The proposal would change the tax treatment of life insurance afforded by the tax laws that have been in effect since income taxes were first enacted. It would treat owners of life insurance policies differently from other taxpayers who hold property that has increased in value but who have not realized that value. These drastic changes from the traditional tax treatment of life insurance are based on a faulty concept of life insurance and would have highly undesirable and inequitable tax administrative, social, and economic effects -- which include the loss of an estimated 50 to 62 thousand insurance sales force jobs. We strongly urge that the proposals to change the current tax treatment of life insurance be rejected and excluded from any tax legislation the Congress may consider.

Why the Proposal Should be Rejected

1. **A life insurance policyholder, like a homeowner, should not be taxed on an increase in value which has not been**

realized. It would be a departure from basic tax rules to tax policyholders on amounts they cannot receive without giving up important rights and benefits.

Taxing a policyholder currently on the increase in the cash value of a life insurance policy would be like taxing a homeowner each year on the appreciation in value of the home even though the home has not been sold. This would be inconsistent with historical and fundamental concepts of tax law and contrary to the traditional principle that the Government should not tax people on unrealized amounts which they cannot receive without giving up important rights and benefits.

Taxing policyholders currently on the increase in the value of their life insurance has no parallel justification in the taxation of bank depositors or certificate of deposit holders. Life insurance cannot be compared fairly to bank accounts, certificates of deposit or other short-term investment instruments. Life insurance is not a short-term investment vehicle. It is a way of providing lifetime protection for families against the risk of death at a fixed cost.

Even when the faulty comparison is made, there are fundamental differences between life insurance on the one hand and bank accounts, certificates of deposit and similar instruments on the other.

Bank depositors are entitled to receive interest without penalty. They have immediate access to the funds that are taxed without having to give up anything. In contrast, life insurance policyholders are not entitled to receive the increase in the value of their life insurance policies. They can, of course, realize the amount by surrendering the policy, but when they do so they lose their insurance protection. To replace this protection, the policyholder would have to apply for new coverage and be subject to new evidence of insurability, a new contestable period and a higher premium rate. These penalties are drastically greater than any associated with the reduction in interest on premature withdrawals from certificates of deposit. This is borne out by court decisions which have held that the restrictions on the receipt of the cash value of a life insurance policy are "substantial restrictions" which preclude the cash value from being taxed as constructively received.

Taxing life insurance policyholders on an amount the receipt of which is subject to "substantial restrictions" does not achieve tax neutrality. Rather, it singles out life insurance for a penalty by withdrawing from it the protection provided in the tax law against taxation of an amount the receipt of which is subject to "substantial restrictions".

2. Given the possibility that the "inside buildup" ultimately will be paid to a beneficiary other than the policyholder as life insurance proceeds, a Congressional Research Service analysis concludes that it is incorrect to impose a tax on the policyholder with respect to such buildup.

The Administration's proposal assumes that it is the life insurance policyholder who, in effect, benefits from, and therefore is deemed to constructively "receive", the increase in the cash value of his or her life insurance. A recent report prepared by the Congressional Research Service 1/ asserts that this assumption fails to take into account the very real possibility that the policyholder will never actually receive these increased amounts.

The Congressional Research Service Report concludes that, from a legal standpoint, the reserve under a life insurance contract prior to maturity or surrender can be viewed as simultaneously "belonging" to the policyholder, the insurer, and all designated beneficiaries. Upon the death of the insured/policyholder (prior to a surrender and

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1/ Robert B. Burdette, "A Legal Analysis of the Treasury Department's Rationale for the Proposed Method of Taxing the So-Called 'Inside Buildup' Under Certain Life Insurance Contracts" (Congressional Pesearch Service, June 11, 1985).

in the absence of policy loans) the status of these simultaneous property rights is clarified and the policyholder's interest in the accumulated reserve under the policy is extinguished. According to the Report, of crucial analytical significance in this very common scenario is the fact that the policyholder will never have received any of the increase in the value of his life insurance upon which the Administration's proposal would impose a tax.

The Report concludes that, in effect, the Administration's proposal assumes that every policy is eventually surrendered -- an assumption contradicted by fact each time a policy matures. To impose a tax on the policyholder based on this faulty assumption is, according to the Report, inequitable and, further, may raise due process concerns.

3. Only last year, Congress thoroughly examined life insurance and set stringent standards to assure that life insurance policies are not used to cloak investments and that only those policies designed to provide insurance protection qualify as life insurance for tax purposes.

The Administration argues that a new tax on life insurance is warranted because insurance may be designed as a tax-favored investment for the benefit of individuals in high tax brackets. To prevent this, and to achieve "tax neutrality" with other investment vehicles, the Administration urges that life insurance policyholders should be subject to a new tax on the increase in the value of their permanent life insurance.

The Administration's argument ignores the major overhaul of life insurance taxation made by Congress only last year. In enacting DEFRA in 1984, Congress made a thorough study of life insurance. It recognized that while all life insurance policies provided protection in the event of death, some policies were so heavily investment oriented that their investment aspects outweighed the protection element. After much study, Congress established stringent statutory guidelines, approved by the Administration, which restrict life insurance tax treatment at both the company and policyholder levels to policies whose predominant purpose is the provision of life insurance protection. These guidelines include a cash value accumulation test and, in the alternative, guideline premium and cash value corridor requirements. Policies deemed "investment oriented" in the judgment of Congress now are not eligible for tax treatment as life insurance. In making its current proposal, the Administration is resurrecting a problem that was considered exhaustively by Congress last year and effectively resolved.

4. In enacting DEFRA, the Administration agreed that the narrowing of the definition of life insurance created all

the more reason for not taxing policyholders on the unrealized increase in the value of their life insurance.

Only recently, the Administration agreed that, with the tightening of the definition of life insurance and the placing of narrower limits on the investment orientation of policies, there was more reason for continuing the long-standing policy of not taxing policyholders on the so-called "inside buildup" in their policies. In 1983, John E. Chapoton, then Assistant Secretary of the Treasury for Tax Policy, testified on this point before Congress. He stated:

> ...[T]he treatment of [inside buildup bears] an important relationship to the definition of life insurance; that is, to the extent the definition of life insurance is tightened, thereby placing narrower limits on the investment orientation of a life insurance policy, there is more reason for allowing favorable tax treatment to the [inside buildup] under policies that fall under a tighter definition.
>
> Tax Treatment of Life Insurance; Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, May 10, 1983, 98th Cong., 1st Sess. 16 (1983).

In accordance with the Administration's position at the time, the definition of life insurance was tightened and narrower limits on the investment orientation of life insurance policies were adopted in 1984.

5. Permanent life insurance is a unique product designed to provide individuals with fixed-cost lifetime protection, not as an investment vehicle. The Administration's proposal is, in effect, an "age-indexed tax" which would penalize future generations of older Americans.

The value in a permanent life insurance policy is a by-product of the level premium method of paying for life insurance. Basically, level premium policies were developed as a means by which policyholders spread the total cost of their life insurance evenly over the duration of their policies. This avoids the sharp increase in premiums that otherwise would occur as the insured individual grows older, to reflect the fact that the probability of death, and hence mortality costs, increases dramatically with advancing age. Level premium life insurance, therefore, makes it feasible for mature individuals to continue their life insurance protection. This unique mechanism has made long-term protection against the risk of death feasible and has made permanent life insurance a staple for American families.

It is sometimes suggested that the same benefit can be obtained by purchasing term insurance. This ignores the difference in the premium structure of permanent life insurance and term insurance. With the former, the premium remains constant. With the latter, the premium increases with the age of the insured. With increasing age, the cost of term insurance for all but the wealthiest people becomes prohibitively high. Term insurance is not a satisfactory alternative to permanent life insurance, especially as individuals grow older.

The dramatic increase with age in the cost of term insurance may be illustrated by reference to a typical premium for a $25,000 one-year renewable term life insurance policy. At age 30, the premium is $85. By age 55, the premium has jumped to $384. At age 60, it is $558 and at age 65, it is $850.

This problem as applied to veterans' life insurance has been a major concern to the Veterans Administration. In advising veterans of the problem, the Veterans Administration has stated:

> Although the initial cost of term insurance is small...the premiums increase with age.... The effect on our term policyholders of the steep insurance premium increases required at older ages has been of great concern to both the Veterans Administration and the Congress.
>
> ...In addition to alerting our policyholders to the increased cost of continuing the insurance on the term plan at each renewal period, we have also made several mass mailings of literature about the advantages of converting to a permanent plan of insurance. (Veterans Administration pamphlet 29-76-1, May 1976, reprinted April 1980).

Thus, term insurance is not a viable alternative for many people. Permanent life insurance overcomes this problem; however, the Administration would impose a new cost problem by imposing progressively higher taxes as policyholders grow older. An illustration of the additional imputed taxable income under the Administration's proposal is shown below for selected ages. The calculations are for a typical $40,000 whole life policy originally issued to a male, age 35 for a $535 level annual premium. The cost of insurance protection is based on the "P.S. 58" rates published by the Internal Revenue Service.

Age	Increase in the Cash Surrender Value for the year	Imputed cost of insurance protection for the year	Total additional taxable income for the year
55	$ 715	$ 383	$1,098
65	734	647	1,381
75	638	1,006	1,644

The illustration does not include the imputed taxable income from the excess of the policy dividend over the policy premium. The dividend exceeds the policy premium when the policyholder reaches age 49.

It cannot be denied that Americans need insurance protection over their lifetimes. Continuing needs include provision for spouses who outlive a breadwinner and provision for non-self-supporting children (e.g., mentally or physically handicapped) who survive the breadwinner as well as continuation of small businesses and family farms through the purchase of the decedent's interest. Lifetime insurance protection is essential for Americans who are marrying and starting families later. In all these situations, no other generally available insurance product can provide the protection of permanent life insurance.

The Administration's proposal would penalize future generations of older Americans who would use permanent life insurance to guarantee that their dependents are protected financially after the insured's death and who would either not purchase life insurance or would be forced to surrender their policies as they grew older to avoid paying increasingly large amounts of tax.

Currently, 24 million people aged 55 and over own cash value policies to protect their dependents; they represent 35 percent of the cash value policyholders. Enactment of the Administration's proposal would interfere with the financial self-sufficiency of future generations of older Americans and would, eventually, result in greater demands being placed upon the Social Security system. Older Americans will face a serious loss of financial protection if permanent life insurance is taxed and becomes too expensive to own. Many survivors depend on life insurance proceeds to provide income during their remaining years. For example, a member company study showed that approximately one-third of all widows rely on life insurance proceeds and Social Security to live. One-fourth of these widows have only their life insurance proceeds to pay for the last illnesses and funeral expenses of their husbands.

The adverse impact which taxing permanent life insurance would have on future generations of older Americans in terms of cost and financial security makes the proposal unacceptable.

6. The proposed new tax would confuse and upset millions of taxpayers. Most Americans believe taxing life insurance is unfair.

A dimension of any tax proposal, including the Administration's base broadening proposal, is the matter of taxpayer perception. In order for a change to be widely accepted, it must be understood by the average taxpayer. If the Administration's proposal is adopted, policyholders will not understand how and why they have additional income when they purchase life insurance.

Theoretically, broadening the tax base could include imputing rent on owner-occupied homes as taxable income. Most taxpayers, however, understandably do not grasp the subtle arguments behind this concept. Therefore, only a few theoreticians would recommend taxing imputed rent in order to broaden the tax base The increase in the value of a life insurance policy presents the same situation. The idea that one receives taxable "income" from the increase in the value of a permanent life insurance policy and that this income should be taxed annually is a suggestion that few people would view as logical or acceptable.

One of the arguments given by the Administration to support its tax reform proposals in general is that taxpayer morale is undermined by the perception of tax loopholes enjoyed by others. While this may be true, morale is affected more adversely when taxpayers are told that their taxable income includes something they do not understand to be income.

According to a recent survey by Yankelovich, Skelly and White, commissioned by the ACLI, four out of five Americans oppose the Administration's plan to tax individual life insurance policies. Seventy-five percent agree that the tax would penalize people who are trying to protect the financial security of their dependents and that it would tax people on money they do not actually receive. Significantly, ninety-one percent said purchasing permanent life insurance would be less desirable than it is now.

7. **Since 1913, Congress has recognized the enormous social good provided moderate- and middle-income American families by permanent life insurance.**

The enormous social good provided by permanent life insurance protection should not be ignored in considering whether a new tax is appropriate. In 1983, $7.0 billion was paid in death benefits with 63% going to wives and children. Of the remaining amount, portions went to preserve existing small businesses, family farms and for other purposes. Two out of three death benefit payments were for less than $25,000. In 1983, 66% of the permanent life insurance policies were purchased on the lives of individuals with an income under $25,000 a year. These numbers clearly demonstrate that the benefits associated with life insurance go primarily to moderate- and middle-income families.

The Administration's proposal includes a chart showing the distribution of the ownership of cash value life insurance by levels of income. The chart indicates that on the average, higher-income families have more cash value insurance than lower-income families. The Administration uses this chart to buttress its argument that permanent life insurance is a vehicle used by the wealthy to shelter investments. This argument, however, is contrary to the evidence.

First, it is not surprising that wealthier families have more cash value insurance than families of lesser means. It is to be expected that the wealthier families as a group would own a greater percentage of all financial assets than persons of lesser means as a group. Wealthier families are likely to have more assets, more expensive homes, larger home mortgages and larger home mortgage interest deductions. This, however, hardly justifies an across-the-board elimination of the deduction for home mortgage interest. Neither should it support eliminating the present tax treatment of life insurance.

What is more relevant, as well as contrary to the impression the Administration would create, is that wealthier taxpayers have relatively little cash value life insurance compared to their other financial assets. The concentration of cash value life insurance among wealthier Americans is much less than the concentration of other financial assets. This conclusion is demonstrated by a recent index of concentration study prepared by a member company. Holdings in selected financial assets of taxpayers with family income in excess of $100,000 were compared with the holdings in those assets of taxpayers with family incomes of $15,000-$40,000. Under this analysis, an index value of one would mean that relative to income, ownership in a particular financial asset is equally concentrated at both the higher- and lower-bracket levels. An index of five would mean that the top income bracket owns five times as much in relation to their income as does the lower-income bracket.

The results for the high-bracket group showed a low index of concentration in passbook savings accounts (.9) and only a modest concentration for cash value life insurance (1.8). On the other hand, the concentration index for the high-bracket group was 3.2 for money market funds, 4.2 for mutual funds, 16.2 for publicly traded stock and 40.8 for tax-exempt bonds. Overwhelmingly, the concentration in financial assets of the top-bracket group was in financial assets other than life insurance. Put simply, the great variance in holdings between higher- and lower-bracket taxpayers is not in life insurance. It is in money market funds, mutual funds, other securities, publicly traded stocks and tax-exempts. If life insurance were bought for its tax-favored income, those in high brackets would flock to it as they do to state and local bonds and other investments. They do not. Rather, investments like bonds and stocks are far more concentrated among wealthier Americans than is life insurance.

In contrast, more than three-quarters of those insured under permanent life insurance policies are heads of households having a total family income of less than $25,000. The average amount of life insurance protection per insured family is a little more than twice the family's disposable personal income. This is clearly the portrait of a moderate- or middle-income individual who purchases permanent insurance to protect dependent family members from economic loss in the event of his or her death. It is not the portrait of a wealthy individual using life insurance as an investment tax shelter.

The Administration's argument that life insurance should be taxed because it is a tax-shielded investment utilized by the wealthy is not substantiated by the facts. Rather than achieving equity, the Administration's proposal would simply impose a new burden on average Americans.

8. Permanent life insurance has provided about $150 billion in long-term funds for investment in the U.S. economy. The industry's capacity to provide future investments would be diminished by the reduction in sales of permanent life insurance covered by the tax.

Taxing policyholders on the increase in the value of their life insurance would make permanent life insurance more costly and less attractive. The reduction in the sale of permanent life insurance stemming from this tax would impair private capital formation and economic growth. Life insurance company funds are invested until they are paid in the form of benefits. Life insurance companies have long been a major source of long-term investment capital.

Through the end of 1983, permanent life insurance has provided over $150 billion in all forms of investments. Life companies ranked fourth among domestic institutional sources of capital, supplying 8% of the total funds flowing into financial markets.

Adoption of the Administration's tax proposal would reduce this important source of capital. By discouraging the purchase of permanent life insurance, the proposal would reduce a major source of premium funds available for investment. Term insurance is a negligible source of long-term investment funds.

It cannot be said that funds which would have been placed in permanent life insurance policies but for the tax would simply become available to the economy through other financial intermediaries. This is not an acceptable answer to the loss of capital flowing from life insurance. First, there is no evidence that funds diverted from permanent life insurance will be saved. It is more likely that the amount will simply be spent rather than accumulated as a contribution to the nation's supply of investment capital. Second, life insurance companies, because of the nature of their contractual undertakings, are a unique source of long-term investment capital. Even if funds lost to insurance companies are placed in other financial institutions, these institutions may not be able to place a similar emphasis on the long-term segment of the market for investment capital.

Given the future shortage of capital funds predicted by many economists, it makes no sense to limit the role of life insurance companies in providing the long-term investment capital that is essential for higher standards of living and the creation of new job opportunities.

9. A new tax on permanent life insurance cuts against the grain of Administration and Congressional policy encouraging Americans to be responsible for the financial security of their families.

The policy of the United States tax law has been to encourage American families to protect themselves through the private insurance system. The necessary effect of increasing the tax burden associated with life insurance would be to increase its cost and discourage its utilization by those least able to assure their financial security by other means. This leaves a gap in family protection which inevitably must be filled by public programs which will be more costly and cumbersome than the present private insurance system.

This Administration and Congress should continue their rational policy of permitting individuals to arrange financial protection for their dependents through encouragement of the private system instead of discouraging these efforts through new taxes.

10. Rather than achieving simplicity, the Administration's proposal introduces new, complex and costly burdens on life insurance companies and their policyholders in identifying and reporting amounts subject to the new tax.

The Administration's proposal has three major stated purposes: fairness, simplicity and economic growth. Taxing Americans on the increase in the value of their life insurance will not achieve fairness and certainly will deter economic growth. Instead of simplicity, the new tax law would produce the opposite. The administrative burden imposed on insurance companies to identify, segregate and report the annual increase in value of permanent life insurance policies would be awesome. The reporting requirement on policyholders would add one more factor to the complexities of reporting taxes. It is hard to imagine a process that would do more to thwart the goal of simplification than taxing policyholders on their life insurance.

Significantly, a study was made in 1972 of whether the increase in the cash value of permanent life insurance should be measured and taxed annually to policyholders. The study concluded that the administrative burdens and complexities which would arise if such a tax were imposed would outweigh any benefit derived from such a tax. Charles E. McLure, Jr., Economics of Federal Subsidy Programs, Joint Economic Committee, July 15, 1972, Part 3, Tax Subsidies.

11. **The Administration's proposal would produce insignificant revenue through 1990 and very likely would not produce significant revenue in the 1990's.**

The Administration estimates that as a result of the repeal of the exclusion of the inside interest buildup no revenue will be raised for the period 1986-1989. Only $200 million is estimated to be raised in 1990.

We believe that the Administration's projection is based on the assumption that life insurance sales would not substantially decline as a result of the new tax. It is in fact highly likely that there would be a major decline in sales of permanent life insurance so that revenues in 1990 would be much less than projected by the Administration and little or no revenue would be generated in future years.

12. **The prospective application of the Administration's proposal is not an acceptable alternative to current law.**

The Administration's proposal would apply to amounts credited on or after January 1, 1986, to policies issued on or after the date of the adoption of the proposal by one of the tax writing Committees of Congress. Existing contracts may be affected to the extent the future death benefit under the policy exceeds the death benefit on the date of Committee action.

To the extent the current millions of existing policyholders are exempt from the complex calculations and incomprehensible additional tax of the Administration's proposal, there would be some encouragement for them to retain their existing insurance protection.

However, the grandfather rule poses much confusion for existing policyholders. Many policies contain provisions and mechanisms that can result in increased death benefits. To what extent are these policies safe under the proposed exemption? Will the normal operation of policy provisions in these instances result at some future time in the loss of the policy exemption? These and other questions pose great uncertainty for existing policyholders.

Applying the Administration's proposal on a prospective basis makes it no less onerous for millions of families that will need permanent life insurance in the future. As to them, all of the reasons given herein for rejecting the proposal remain as valid as ever. The undesirable and inequitable social, economic, and administrative effects would still be inherent in the proposal, even if grandfathering were included. Taxing people on the increase in the value of a contract they own when they cannot receive any cash income without giving up important rights and benefits is wrong, regardless of whether it is a contract they own now or a contract they will buy in the future. Imposing an incomprehensible age-indexed tax on level premium life insurance so that people cannot afford to buy and keep lifetime protection is also wrong.

For all these reasons, the Administration's proposal to tax policyholders on the increase in the value of their permanent life insurance should be rejected and the current tax rules which were thoroughly reviewed by Congress just last year should be retained.

B. PROPOSED TAXATION OF DEFERRED ANNUITIES

Under current law, an owner of a deferred annuity is not taxed on the increase in the cash value of his or her contract until he or she receives it. This has been the tax rule with respect to deferred annuities since the inception of the income tax. The Administration proposes that the owner of a deferred annuity be taxed each year on the annual increase in the cash value of the annuity after taking into account any surrender charge or penalty. In addition, a special rule would be provided to prevent a contractholder from being taxed on the unrealized appreciation of assets underlying a variable annuity policy. The proposal would be effective for all investment income credited on or after January 1, 1986, to contracts issued on or after the date of adoption of the proposal by one of the tax-writing Committees of Congress.

In essence, under the Administration's proposal, the cash value in an annuity is equated to a savings fund with the earnings on the fund being subject to tax on the same basis as interest earned on a bank account. Thus, the owner would include in interest income for any year any increase in the amount by which the annuity's cash value exceeds the owner's investment in the contract.

For the following reasons, we are strongly opposed to any change in the current tax treatment of annuities.

Why the Proposal Should be Rejected

1. Congress examined the tax treatment of deferred annuities twice in the last three years. It added penalties under the tax law on premature withdrawals to assure that deferred annuities are used to provide long-term retirement protection and not as short-term investment vehicles. After making these changes, it concluded that it "believed that the use of deferred annuity contracts to meet long-term investment and retirement goals was still a worthy ideal."

The issue of how individual deferred annuities should be taxed was given consideration by Congress under TEFRA in 1982 and again under DEFRA in 1984. Congress addressed the concern that deferred annuities might be used to shield short-term investments from tax. It resolved this problem by requiring that if a policyholder makes a premature withdrawal from an annuity, the amount withdrawn will come first from currently taxable income and by enacting strict rules which penalize annuity owners for premature withdrawals of funds. These restrictions assure that deferred annuities are used as long-term retirement vehicles. With these changes, it was concluded that "the use of deferred annuity contracts to meet long-term investment and retirement goals was still a worthy ideal." [Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961, 97th Congress; Public Law 97-248), p. 361]. In sum, the fundamental tax argument raised by the Administration to support its proposal -- that deferred annuities are comparable to other savings instruments with other financial institutions -- has already been addressed by Congress.

2. **Current law does not allow deferred annuities to escape tax; it only permits a deferral of tax. All income is eventually taxed.**

The present rules for the taxation of annuities provide an equitable means of taxing these contracts. These rules do not provide for forgiveness of tax. They only provide for a deferral of tax.

The premiums for non-qualified annuities are paid with after-tax dollars. The annuitant is treated as being in receipt of annuity income when annuity payments commence. Generally, each payment is considered to consist of a ratable portion of the owner's investment in the contract (premiums) and investment income. The investment income portion is taxed at ordinary income rates.

3. A deferred annuity is a unique vehicle for assuring financial security in retirement because unlike any other form of retirement savings, it guarantees a stream of retirement income which cannot be outlived.

A deferred annuity contract is a unique vehicle for assuring financial security and independence after retirement. Unlike any other means of providing for retirement, deferred annuities provide protection against the possibility of outliving one's financial resources. Traditional deferred annuities provide guaranteed retirement income of a predetermined amount for life -- an individual can never outlive an annuity. Variable annuities contain the same mortality guarantees but the income produced by the contract may not be determined until income payments are made.

Millions of Americans use one or the other of these contracts as an important element in their planning for retirement.

To provide for financial security in their later years, Americans must combine formal retirement plans with personal savings. By discouraging the purchase of deferred annuities, the proposal deters Americans from using a particularly effective and important means of accumulating personal savings to assure a reasonable quality of life after retirement. Government policy should continue to permit individuals to make adequate provision for their retirement instead of discouraging self-reliance through proposals such as the present one to change the taxation of deferred annuities.

4. Adoption of the proposal would mean a departure from the basic tax rule that an individual should not be taxed on amounts the receipt of which is subject to substantial restrictions. An annuity owner cannot obtain the amounts which would be taxed without giving up valuable rights and guarantees.

The Administration's proposal would tax owners of annuities each year on increases in the value of these contracts although they have not received these amounts and their rights to receive these amounts are subject to substantial restrictions, as described below. Taxing annuity owners on this basis would be contrary to the long-standing tax law rule that income, the receipt of which is subject to substantial restrictions, is not constructively received.

Taxing annuity owners currently on what the Administration's proposal terms the "investment income" is not justified by the way bank depositors are taxed. Bank depositors are entitled to receive, without any limitation or constraint, the savings account interest on which they are taxed. They have ready access to the funds on which tax is paid. In contrast, an annuitant can generally obtain the cash value of the contract only by surrendering the annuity and losing the important guarantees which it provides. To replace these guarantees, the annuitant would have to apply for a new deferred annuity contract, pay new acquisition costs and, to maintain the same level of annuity, pay a higher premium rate. These restrictions preclude a determination of the constructive receipt of values in an annuity by the annuitant.

5. Prospective application of the Administration's proposal is not an acceptable alternative. The proposal is fundamentally inconsistent with encouraging individuals to provide for their own retirement, which is a reasonable objective of a national retirement policy.

The Administration's proposal would apply to amounts credited on or after January 1, 1986, to policies issued on or after the date of the adoption of the proposal by one of the tax-writing Committees of Congress. Existing contracts would continue to be untaxed until withdrawal or distribution of funds from the policy.

Despite the prospective application of the Administration's proposal, all of the reasons given herein for rejecting the proposal remain valid. The undesirable and inequitable social effects would still be inherent in the proposal, even if grandfathering were included. Taxing people on the increase in the value of a contract they own when they cannot receive any cash income without giving up important rights and benefits is wrong, regardless of whether it is a contract they own now or a contract they will buy in the future.

Policy loan interest deductibility. One additional Administration proposal that will adversely affect life insurance company policyholders relates to the deductibility of non-business interest, including interest on policyholder loans. This Administration proposal would limit the deductibility of all non-business interest (other than mortgage interest on the taxpayer's principal residence) to $5,000, plus the amount of the taxpayer's net investment income. We believe this proposal should be eliminated.

As a preliminary matter, the Administration's interest proposal favors one type of borrowing (i.e., borrowing for home mortgages) over all others. We can see no principled basis for such a discriminatory rule. Its likely result will be to skew consumer borrowing toward residential mortgages when other assets, such as a permanent life insurance policy, may be a better credit source for any number of reasons, including interest rates, terms, etc.

There are additional sound reasons for not imposing statutory limits on non-business borrowing. A valuable attribute of property is its ability to be used as collateral. The limits under the Administration's proposal impair the viability of property as collateral, and thus deprive individuals of an important property right upon which they may have relied.

Finally, with respect to life insurance, the loan feature of the life insurance policy enables the policyholder to borrow on his policy for matters such as financial emergencies or education of children without the necessity of giving up his guaranteed insurance protection.

C. PROPOSED ELIMINATION OF SECTION 401(k) PLANS

Although we have previously filed a comprehensive statement on the Administration's proposals affecting employee benefits, we would like to comment on one new Administration proposal in the employee benefit area -- that is, the proposed total elimination of Section 401(k) of the Internal Revenue Code. Our prior statement commented on the then proposed modification of the Section 401(k) rules. We now understand that, in the stated interest of achieving revenue neutrality, Treasury Secretary Baker is proposing outright repeal of Section 401(k). We would therefore like to take the opportunity to present our views on this new proposal in today's statement.

Section 401(k) plans, also called "CODA's" (cash-or-deferred arrangements), were first permitted by the Revenue Act of 1978. Since 1982, these plans have rapidly become an important element in providing retirement security for American workers. The Employee Benefit Research Institute (EBRI) reports that 4.8 million private-sector employees were offered 401(k) plans in 1983. EBRI estimates further that approximately 19 million employees are currently eligible to participate in 401(k) plans. A 1985 survey sponsored by the Employers Council for Flexible Compensation suggested that 401(k) plans may now cover 28 percent of the private-sector work force.

Section 401(k) plans are employer-sponsored programs that permit employees to defer current compensation to meet future financial needs. In many cases, employers make discretionary contributions to match those made by employees. Under present law rules, amounts contributed to the plan are not includible in the employee's gross income at the time of contribution, provided that both normal qualification rules and a special set of requirements are met.

As detailed, below, we strongly oppose the Administration's proposal to repeal Section 401(k). We also wish to note our continued opposition to the limitations on Section 401(k) -- including the very restrictive non-discrimination rules -- contained in the Administration's earlier proposal.

Why the Proposal Should be Rejected

1. Section 401(k) plans provide employees with an attractive savings alternative for retirement.

In proposing to eliminate 401(k) plans, the Administration is implicitly selecting IRA's as the appropriate vehicle for the receipt of deductible retirement plan contributions by individuals to the exclusion of their existing plans. This would be a serious mistake and short sighted tax policy. The use of effective group arrangements, such as Section 401(k) plans, for the provision of retirement benefits should also be encouraged. They each clearly coexist with IRA's.

Employer-sponsored plans are a sound and cost effective way to provide for retirement. For example, the "Final Report by the President's Commission on Pension Policy," 1981, recognized that "a major objective of retirement income policy should be to insure that today's retirees and tomorrow's elderly are able to maintain a reasonable standard of living in their later years." In view of this, the President's Commission recommended the expansion of the role of employer-provided deferred compensation plans.

To the extent the retirement needs of employees can be met by employer-sponsored qualified plans, it will not be necessary for the government to provide additional aid to retirees.

Section 401(k) plans have proven to be a very effective vehicle for expanding retirement income protection at middle- to low-income ranges. A 1983 study by Hewitt Associates demonstrated that IRA's, by contrast, are not an effective vehicle in this regard. According to that study, only 16.9 percent of the work force had established IRA's and that usage was highest among the higher paid employees. Only 11 percent of workers earning less than $20,000 established IRA's compared with 58 percent of those earning more than $50,000. Contrasting these participation rates with 401(k) plan usage, two recent surveys, one by Hewitt Associates and a second by Towers, Perrin, Forster & Crosby, report that 60 and 63 percent, respectively, of eligible employees were participating in 401(k) plans at the end of 1984. As to distribution of 401(k) plan usage by income level, Census Bureau data tabulated for 1982-3 indicate that low-income workers, earning between $5,000 and $10,000, were three times more likely to participate in a 401(k) plan than in an IRA. Middle-income workers, earning up to $29,999, preferred 401(k) plans over IRA's two to one.

2. Section 401(k) plans distribute pension benefits across income classes and must meet very strict non-discrimination requirements. These plans are subject to audit to assure that all requirements are observed.

Section 401(k) plans must satisfy special and rigorous non-discriminatory requirements. The special 401(k) rules prohibit discrimination in favor of "highly compensated employees" with regard to deferred amounts. Highly compensated employees may not contribute more than an allowable percentage of their compensation to a 401(k) plan. This percentage is directly influenced by the extent of participation in the plan by rank and file employees. Unlike IRA's, these plans are subject to audit to assure that all requirements are observed. It is, therefore, in the interest of the highly compensated employees for the employer to encourage and to sustain broad and meaningful plan participation on the part of rank and file employees.

3. Eliminating Section 401(k) plans would significantly disadvantage employees in businesses which cannot otherwise afford a retirement plan.

In 1981, the President's Commission on Pension Policy identified coverage as one of the key problems of private sector plans. It was concerned that only half of the work force was covered under retirement plans. In many instances, CODAs are established by employers who could not otherwise afford to sponsor a qualified retirement plan for their work forces. A nationwide survey, commissioned by the Employers Council for Flexible Compensation, indicated that almost a half-million small businesses offer 401(k) plans to their employees. For 37% of those businesses, the 401(k) plan is the only retirement program.

The popularity of CODAs is due, in part, to their value as a lower-cost employer-sponsored retirement plan. Through salary reduction, employees are able to maximize the amount of their retirement savings beyond the amount, which the employer can afford to contribute on their behalf under a more traditional arrangement. The Administration proposal to eliminate Section 401(k) plans would, in practice, discriminate against employees of those employers unable to afford conventional retirement plans.

4. The amounts involved under Section 401(k) plans do not escape tax. Taxes are simply deferred until the employee retires and receives the income.

The key feature of a 401(k) plan is that participants can defer taxes during their working years on income set aside for retirement and they pay taxes on that income as they receive it after retirement. There is no escape from paying taxes.

5. Employer-sponsored retirement plans encourage capital formation.

It is widely agreed that private savings and capital formation should be encouraged. One way this goal can be achieved by Congress is through encouragement of broad-based retirement plans maintained by employers to provide income security for great numbers of employees. Section 401(k) plans clearly fall within this category. Capital formation achieved through employer-sponsored plans will benefit the economy while at the same time employees will obtain the benefit of participation in employee benefit of retirement income security.

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CONCLUSION

To conclude, the ACLI is strongly opposed to the Administration's proposed tax increases on life insurance companies and their policyholders. Moreover, we strongly object to both the new Administration proposal to repeal Section 401(k), as well as the Administration's prior proposal to limit Section 401(k). These proposals are not grounded on sound tax policy. Moreover, they would have a serious negative impact on capital formation, job creation and the financial security of millions of Americans.

As we mentioned at the outset, Congress has just completed a thorough review and revision of the taxation of life insurance companies and their policyholders. The Administration was an active participant in this process, which addressed most of the issues now being raised. It is difficult to understand why the Administration is asking to re-open this matter.

I appreciate this opportunity to present the views of the ACLI, and would be glad to attempt to answer any questions or to provide any further information that would assist you in your deliberations.

STATEMENT OF HARRY PHILLIPS III, PRESIDENT, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING, WASHINGTON, DC

The CHAIRMAN. Mr. Harry Phillips. And, Mr. Phillips, I have a note from Senator Moynihan expressing his regrets. He says he's in an all-day negotiating session and can't be here, but he sends his regards.

Mr. PHILLIPS. Thank you, Mr. Chairman, and Senator Moynihan. I am the president of the Association for Advanced Life Underwriting. We have 1,250 members who place in excess of $20 billion of face value of life insurance annually. In my private capacity, I am CEO for an organization selling and servicing life insurance.

Our members ask the buyers of life insurance to forego enjoyment of current expenditures or possible speculative gain in order to provide family protection or retirement income. This essentially selfless task by the buyer would be made prohibitively difficult by the tax on the inside buildup. Such a tax would create a product much like term insurance in that the policy will get prohibitively expensive as one gets older. Our figures show that it is an age-related, and therefore discriminatory, tax.

Life insurance has worked because it exists not only when purchased, but also at time of death. If it were not for life insurance, the Government would be providing welfare for many more families than it now does. The inside buildup tax appears to have been abandoned (at least by the House Ways & Means Committee) for the moment, except for annuities. However, a new loan tax option has been suggested to that committee—an option that may, on the surface, appeal to sense of sympathy because it equates loans on life insurance with loans on qualified pension plans. But there is a vast difference between those types of loans and their tax treatment.

The pension plan assets to be borrowed are themselves created with tax deductible employer contributions. The life insurance cash values are created with dollars paid into premiums after taxes have been paid. That's a substantial, and our purpose here, a difinitive difference.

The proposal to place a tax burden on loans has a number of aspects. It not only forbids deduction of interest, but it also requires that any existing loan on policies issued after September 25 be taxed as income. It's unclear to me in the Ways and Means proposals whether the partial distributions should be taxed in the same way. But they certainly would be under some of the earlier proposals.

The nondiscrimination rules for qualified pension plan and other fringe benefit plans, which have been proposed, are intended to provide fairness. But there is inherent discrimination against small business in these proposals. If you follow through the complex twists and turns of the new proposed rules large businesses would be able to provide different kinds of benefits and levels of benefits, where small business would not.

Even if substantial revenues were involved, the proposals to place addtional taxes on life insurance would be ill-advised. Since little revenue is involved, we are at a loss to understand why this is being considered.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared written statement of Harry Phillips follows:]

STATEMENT OF HARRY PHILLIPS III, PRESIDENT OF THE ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

My name is Harry Phillips and I appear before you today as president of the Association for Advanced Life Underwriting (AALU). In my private capacity, I am president of Management Compensation Group New York, Inc., a life insurance brokerage firm specializing in executive benefits. I reside in Hartsdale, New York, and maintain my business offices in New York City. I am accompanied by counsel, Gerald H. Sherman and Stuart M. Lewis of the Washington, D.C. law firm of Silverstein and Mullens.

AALU is a nationwide organization whose membership consists of approximately 1,200 life insurance agents and others engaged primarily in various aspects of life insurance marketing. Our members specialize in advanced life underwriting and, collectively, are responsible for annual sales of life insurance in excess of $2,000,000,000, mostly in circumstances involving complex factual situations. Much of the work performed by our members relates to small businesses and deals often with qualified retirement plans and other employee compensation techniques. We take great pride in the life insurance industry we represent and in our knowledge of that industry and of the death benefit arrangements it offers to the American public.

We appreciate the opportunity to testify before you today and to offer our insights on the life insurance and related portions of the President's tax proposals to the Congress (sometimes here referred to as the Administration's proposals or Treasury II).[1]

AALU opposes the President's recommendations (1) to tax the annual increases in life insurance and annuity cash values, (2) to increase the tax on life insurance companies through cutbacks in reserve and other company deductions, (3) to impose limitations on the deduction of consumer interest, and (4) to revise the approaches under which various forms of welfare benefits and qualified retirement plans, such as section 401(k) plans, are subject to tax.

We urge the Congress to reject the President's initiatives in these regards.

Our testimony will focus primarily on the proposals to tax life insurance cash value increases and to add to the tax burden of employee benefit plans. We emphasize these subjects partially in the interests of conserving the time of the readers and auditors of this statement, but more importantly because our expertise runs heavily to the life insurance policy and employee benefit subjects. It is in these areas that our views can be of more help to the Committee. We do not mean to imply that our stated opposition to the other aspects of the Administration's recommendations are any less strong or that the subjects are any less important to the health of the American economy and tax system.

With respect to the President's proposal to increase the tax on life insurance companies, we defer to the American Council of Life Insurance (ACLI), the organization representing most of the life insurance companies in this country. In its testimony, it will develop in detail the reasons why the President's proposals in this regard are inadvisable.

The President's proposal to limit the consumer interest deduction (by combining consumer interest with investment interest and limiting deductions annually to $5,000 in excess of investment income) will have a generally chilling effect on consumer purchases, including purchases of life insurance policies. The country would be ill-served by any proposal that thus impedes a freer flow of commerce. The increased after-tax cost of borrowing against the collateral of cash value life insurance will tend to discourage people from purchasing such policies and, for reasons explained more fully hereafter, will cause a reduction in the country's total stock of after-death protection—an unfortunate result that certainly should not be advanced by our tax laws.

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[1] Published by the Treasury in May 1985.

The purchase of after-death protection, no less than of a primary residence, should be encouraged through full availability of the consumer interest deduction. We, therefore, oppose a limitation on the deductibility of that interest.

Many of the reasons we put forward in later portions of this statement for why the Administration is ill-advised in proposing a current tax on life insurance cash value increases apply to the proposal to impose a tax on deferred annuity cash value increases. While deferred annuities do not typically offer life insurance protection, they do provide a form of privately financed retirement benefits, the availability of which should be encouraged. Furthermore, such annuities do not offer an escape from taxation. All earnings thereon are subject to tax on a deferred basis at the point of payout.

Through deferred annuities an individual can arrange and pay for his retirement on a basis which guarantees him payments for the remainder of his life. In addition, this benefit is in place without the federally funded assistance which is available through deductible contributions to the qualified retirement plan system about which we will later speak. In brief, the premium payments for private annuities—as contrasted to contributions to qualified retirement plans—are not deductible.

The Administration should not be supported in its recommendation to do away with one of the least costly and most efficacious approaches to the provision of retirement income.

The Treasury II proposals are specifically premised on fairness, economic growth and simplicity—each a most laudable basis on which to structure tax reform. Unfortunately, not one of those aims is served by the proposal to subject to tax the excess of each year's increase in a life insurance policy's cash value over the annual cost to the policyholder of generating that increase. Furthermore, this proposal, which cannot find a grounding in the professed philosophical base of the President's tax program, likewise cannot find a pragmatic refuge in the contention that it is a funding source for income tax rate reduction. By the Administration's own figures, the projected increase in federal revenues to be derived over the next five years from burdening life insurance cash values with tax is at best inconsequential.

1. Life insurance cash values are not analogous to bank accounts, may not be reached except at the cost of relinquishing life insurance protection, and should be treated for tax purposes in the same manner as increases in the value of a residence.

The President's proposal misconceives the basic nature of life insurance and its cash value component. Treasury II equates cash value with bank accounts, observes that bank account interest is taxed each year as it accumulates, and concludes that the increase in cash values should likewise be taxed each year. In fact, life insurance cash values are not bank accounts, are not utilized for the same purpose as bank accounts, are, unlike bank accounts, not available on an unrestricted basis to the reach of the policy owner, and should not be subject to the same tax rules as bank accounts.

The owner of a typical bank account can be at his whim take down any interest that has accumulated in his account (to be used for any purpose he wishes), while continuing to maintain that account for its intended purpose, i.e., the earning of interest thereon. Since life insurance cash value is an integral part of life insurance protection and the policy in which that protection is embodied, it is not possible to reach that cash value or any portion of its earnings without either relinquishing the right to life insurance protection or paying an interest charge for the temporary acquisition, through loan, of that cash value. Thus, without the relinquishment of valuable rights the cash value is unreachable by the policy owner.

A much more accurate analogue to cash value taxation would be the tax principle which the Revenue Code applies to the increase in value of personal residences. Over the past 20 years inflation and other factors have caused substantial increases in real estate price levels. As a consequence, most personal residences today have values well in excess of original cost. However, not one penny of that increase is subjected to tax until it is realized by sale and conversion to sales proceeds. It is clearly recognized that, although the homeowner may borrow against his increased equity, he is not then taxed on that increase. Only when he sells his residence and thereby relinquishes the use of its shelter function is he burdened with tax on the increase in the residence value.

Virtually the identical situation prevails in the case of cash value life insurance. Indeed the owner of the policy may convert that cash value to cash. However, he can do so only at the cost of relinquishing the policy and the life insurance protection inherent in it. That protection, no less than the shelter offered by residences, deserves cognizance as a determinative limitation on the timing of the tax burden to be applied.

In more standard and technical tax terms, neither the owner of the life insurance policy nor the owner of the residence has been in receipt (constructive or otherwise) of the amount to be realized on disposition, in one case, of the cash value and, in the other case, of the residence.

2. The imposition of a tax on cash value increased will insure a discriminatory reduction in death benefit protection at the older ages.

The cash value component of a life insurance policy constitutes a technique whereby an insured, in return for the payment by him of equal annual premiums for the remainder of his life, can purchase a contract which commits the issuing company to provide a death benefit at the insured's death, no matter how long he lives. Without cash values, viable after-death protection would not be economically realistic beyond ages 65 to 70. Thus, our older citizens, the segment of the population which needs it most, would lack life insurance.

By the very nature of our increasing mortality, the cost of life insurance increases with each passing year. By the relatively simple expedient, in the early years of a policy's life, of paying premiums in excess of mortality costs, amounts are accumulated to be available for the payment of mortality costs in the later years in excess of the premium payment made in those years. By a careful mathematical construct encompassing the use of cash values, we can develop lifetime, annual premium policies which guaranteed affordable protection indefinitely.

There are two simple lessons to be learned from this basic analysis of the structure of cash value life insurance.

First, such life insurance cannot possibly compete—as an alternative investment—with standard forms of investment, since, unlike those forms, cash value life insurance is burdened with the cost of providing life insurance protection. If there is not some existing need for that protection, the purchase of cash value life insurance would be grossly ill-advised. The investor is better served by putting what would otherwise be the pure life insurance premium cost into a basic form of investment that would provide him with a financial return irrespective of the event of death. We here hearken back to the false analogy to standard bank accounts, as put forward in the Administration's proposal.

Second, the form of life insurance which is available on a short-term basis and does not offer a guarantee of lifetime protection (i.e., term insurance), while it has many legitimate uses, is not a substitute for cash value life insurance. As a consequence, it is totally unrealistic to expect that when, as a natural result of the President's proposal, people stop buying cash value life insurance, they will simply substitute equal amounts of term insurance. That substitution may to some extent occur at younger ages when term insurance on an annual basis is cheaper than cash value insurance. At the older ages, the premium cost becomes prohibitive and the policy is cancelled—precisely at the time when the likelihood of death is increased and life insurance is most needed.

It is in recognition of this fact that the Veteran's Administration has historically urged its veteran/insureds, particularly as they approach age 50, to convert their term protection to permanent cash value insurance.

It is unrealistic to anticipate that term insurance will even be offered at older ages at anything less than very high premium rates, since insurance companies must protect themselves against the risk of adverse selection, i.e., the probability that the only persons who will pay for term insurance are those who know that ill health makes their death more probable than the assumed likelihood of death embedded in the term insurance premium.

We reject categorically that this country is well served by any proposition that virtually mandates an absence of life insurance protection precisely when it is most needed. It is difficult to conceive of a proposal that is more grounded in age discrimination.

3. Economic growth and capital formation will be retarded by a tax on cash values.

The life insurance industry has added approximately $150 billion to this country's inventory of capital, almost all of that through cash value life insurance. If the issuance of such insurance is reduced to insignificance this capital formation function will no longer be operative.

One can state with an air of authority, as does the Administration, that the dollars that otherwise would go into cash value life insurance will naturally flow into other forms of investment. That statement, however, is premised in pure conjecture. In fact, it is not unreasonable to expect that large portions of the investment that would otherwise be made in cash value life insurance will simply be dissipated and will find their way into consumer purchases. While we do not denigrate consumption expenditures as a necessary component of a healthy economy, their generation at the direct cost of depleting sorely needed capital formation, which is almost certain otherwise to have taken place, is a proposition that neither we nor, for that matter, economists of most philosophical and political stripes would find acceptable. The Administration's professed aim of encouraging economic growth is here simply honored in the breach.

Even if one steps down for a moment from the heights of macroeconomic overview and examines the effect of the proposal on merely one industry, the life insurance industry, a rather catastrophic degree of dislocation can be expected. While it is likely that most of the people who will no longer find employment in the life insurance industry (probably numbering in the thousands) will ultimately be employed in other endeavors, the dislocation effects and turmoil from unemployment in the industry cannot be thought to be among the benefits of this proposal.

The predictions of a general economic downturn in the near future are pervasive enough. We needn't add a stumbling life insurance industry to the recessionary cauldron.

4. Simplification and cost containment are best served by a continuation of the current approach to the income taxation of life insurance.

The Administration has said that its recommendations will substantially simplify our tax system. If one believes, as we do, that implementation of the cash value life insurance proposal will virtually eliminate cash value life insurance, we would agree that such implementation will produce a much simpler tax system, unless of course one has to factor in the tax complexities resulting from the bankruptcy of a major American industry.

On the other hand, if the Administration is right and cash value life insurance will survive in a meaningful vibrant and healthy way, the degree of complexity engendered by the Administration's proposal can hardly be surpassed. Complex computations involving assumed term insurance costs will have to be undertaken by every life insurance company for every policyholder. That information will then have to be processed and submitted to each individual policyholder so that he may include in his taxable income the amount so reported to him. Thus, we will have a whole new stratum of computation and reporting which did not exist prior to the proposal.

The addition of undesirable complexity is apparent. Perhaps more importantly, this complexity will carry with it a burdensome administrative cost and will add yet another level of bureaucracy in the private sector (the insurance industry) and in the government (the IRS). To contend that this country does not need the complexity, the cost or the bureaucracy is to belabor the obvious.

In 1983 and 1984 the Congress, in a gargantuan effort, reviewed and restructured the entire overall pattern of taxation of the life insurance industry. During the course of that examination it considered and rejected the imposition of a tax on cash value increases. The appropriate level and manner of taxation was reached after two years of constant, intensive, virtually daily effort.

Now, before tax returns are due for the first full year of operation under the new statute, we have a proposal to reject that effort and impose an entirely new system of taxation on the industry at the policyholder level. This year the Congress with its overcrowded calendar, in bright-line comparison with the conditions of 1983 and 1984, can devote only a small portion of its time to this subject. It is inconceivable to us that the Congress' endeavors in those prior years are not worthy of at least the opportunity to succeed. The President's proposal thus (and, giving it the benefit of the doubt, with probable inadvertence) makes a mockery of those prior Congressional efforts.

5. At excess public cost a new federal funded life insurance system will inevitably be developed to replace the benefits now supplied by privately generated cash value life insurance.

If the Administration succeeds in its efforts to undermine the life insurance industry, a huge gap in death benefit protection will quickly and inexorably develop. It is one thing to state, as does the Administration, that the life insurance industry will have to stand on its own without any assistance from the federal tax system. It is quite another to stand by and do nothing while our death benefit structure corrodes.

It is inevitable that the Federal Government will be required to take up the slack, perhaps through the social security system, perhaps through a design not yet envisioned. One thing is certain, however. The country will not accept an edifice of after-death protection that is decidedly weaker that its retirement system. A more costly, less efficient and more bureaucratic public structure will, doubtless, be put in place to patch over the damage that will be done if life insurance cash value increases are subjected to tax.

We submit that no legitimate purpose would be served by permitting this scenario to play itself out. There is no need to burden the Government with a function which is now being discharged with great dispatch and effect by the private life insurance system.

6. The proposed taxation of cash value life insurance raises no meaningful revenue by the administration's own reckoning.

The Administration predicts that during the first three years of cash value life insurance taxation there will be no increase in Federal revenues. In the fourth year the increase will be negligible and in the fifth year there will be a revenue increase of $200 million.

In light of this comparatively insignificant collection of revenues which will in no way enhance income tax rate reduction, is the game worth the candle? Is it worth it to put in jeopardy an entire industry and undermine an effective death benefit system on technical and conceptual grounds which, at a minimum, are subject to substantial doubt? The question answers itself. The Administration's proposal to tax life insurance cash value increases should be quietly laid to rest.

The President's proposals would make numerous, extensive modifications in the rules applicable to retirement and welfare plans. Treasury II would change the nondiscrimination rules applicable to pension and welfare plans, it would impose numerous new excise taxes on plan distributions and benefits, would virtually eliminate the availability of the most successful employer-sponsored savings and retirement program yet developed (section 401(k) plans) and would change, without adequate grandfather protection, taxation rules that have existed for well over 30 years. These changes would, in effect, constitute a sweeping revision of the long-established employee benefit plan structure under the Internal Revenue Code.

1. In general the administration proposals require further study, are not necessary for tax reform, overburden the statute with complexity and excessive change, and are generally harmful to the public.

a. *Proposals need further study.*—AALU strongly recommends that these proposals not be adopted at the present time. Instead, the proposals should be separated from Treasury II and studied in greater detail at a later time for possible enactment as part of a more carefully evaluated study of the long-term goals of the employer-sponsored retirement plan system. Congress has recently, through hearings and other efforts by both the tax and the labor committees begun to develop long-term retirement goals for the nation. Until these goals are fully developed and adequately studied, it would be premature to make the types of sweeping changes being proposed as part of Treasury II.

The need to remove these provisions from Treasury II is further reinforced by the fact that Treasury II constitutes a major revision of the overall Internal Revenue Code. As a consequence, Congress and employers have necessarily not had adequate time to study the employee benefit provisions. Many of these proposals are new. Some were not even contained in Treasury I. Without adequate study, it would be a mistake to move forward on legislation affecting employee benefits.

b. *Proposals not necessary for tax reform.*—The employee benefits provisions in Treasury II are not necessary to the President's proposals. Treasury II is designed to accomplish the objectives of "fairness, growth and simplicity." The employee benefit proposals do not promote simplicity, rather, they create greater complexity. The proposals do not promote the growth of employee benefits, but may well have the effect of reducing the benefits available to employees. Whether the new proposals are more fair is debatable, but clearly from many employers' points of view, they are substantially less fair since they will lead to benefit reductions and reductions in employee savings. Thus, the employee benefit proposals in Treasury II are not consistent with the overall objectives of Treasury II.

The revenue raised from the employee benefit provisions is not critical to the enactment of the rate reductions in the President's proposals. Almost all of the employee benefit changes proposed raise insignificant amounts of revenue. Of the 16 employee benefit proposals in Treasury II, only four raise significant revenue. The proposals to tax health insurance is the most significant among these and second is the proposal to change the three-year basis recovery in section 72(e). The provisions of section 72(e) primarily affect distributions from governmental plans although they are used by private plans as well. Thus, of the remaining two revenue-raising provisions, the only one that produces revenue that is substantial in relation to the overall revenue aspects of Treasury II is the changes dealing with section 401(k) cash or deferred plans which, over a five-year period, is estimated to raise approximately $10 billion in revenue.[2] This revenue gain, however, may be insignificant when the cost of lost retirement savings and the increased burden on the Social Security system is considered.

While there is revenue gain from the employee benefit provisions, the revenue is well within the parameters of the amount that would be considered insignificant in terms of the rates being established under Treasury II. Since the proposals do not promote the primary goals of fairness, growth and simplicity and do not raise a critical amount of revenue insofar as the proposed tax rate structure is concerned, these proposals are not necessary to this tax effort.

c. *Legislation has been too frequent.*—The employee benefit provisions in Treasury II should also not be enacted at this time because the benefit community needs time to recover from the overwhelming burden of legislation and regulations that has developed in the last 10 years. Congress has frequently enacted major legislation affecting employee benefits. This has created an enormous backlog of regulation projects by the Internal Revenue Service, the Pension Benefit Guaranty Corporation, and the Labor Department. Employers and plan administrators are frequently acting in the absence of clear rules, often in areas of major importance. The Treasury Department and the Internal Revenue Service are overburdened in their efforts to keep up-to-date with just the minimal necessary plan guidance. Frequent change is not compatible to programs that are designed for long-term retirement security.

Just since 1979 there have been seven major bills affecting employee benefits generally and many more in the fire years before 1980. The legislation since 1979 includes the following:

1984.—Retirement Equity Act and Tax Reform Act of 1984 /Deficit Reduction Act.

1983.—Social Security Amendment Act of 1983.

1982.—Tax Equity and Fiscal Responsibility Act of 1982 and subchapter s revision act of 1982.

1981.—Economic Recovery Tax Act of 1981.

1980.—Multiemployer Pension Plan Amendment Act of 1980.

In addition, the Internal Revenue Service, the Labor Department and the Pension Benefit Guaranty Corporation have a backlog of well over 100 regulation projects affecting employee benefits. Some of these regulation projects go back over 10 years to the dawn of ERISA. The Internal Revenue Service has not yet, for example, issued regulations on how employees who receive lump-sum distributions are to be taxed on those distributions.

The frequency of these changes will have long-term adverse affects for the retirement security of employees. Congress should allow the retirement community a breather in which to digest current rules while Congress develops long-term goals that are to be established and followed in its legislative efforts. This would bring greater cohesiveness and consistency to employee benefits.

d. *Harm to employees, employers and society.*—Enactment of the employee benefit proposals in Treasury II will harm employees, employers and society generally. Harm to employees will result from cutbacks and loss of coverage in employees benefits as well as from lost savings. One of the major thrusts of the employee benefit proposals is to restrict and virtually eliminate the more popular employer-sponsored retirement savings vehciles available to employees. This will cut down the opportunity and willingness of employees to save for retirement, thereby diminishing the retirement income available to those employees. Addition of new non-discrimination rules and limits will cause employers to cut back on available pension and welfare benefits to employees leaving employees with less benefit coverage. Some of these cutbacks will occur through employers simply dropping programs that are difficult to maintain under the proposed new rules and others will result because employers will be more restrictive in the amount of benefits provided under existing programs.

Employers will be harmed because they will once again have to incur major costs for updating their retirement programs. These costs, which will run into many millions of dollars, will effect the long-range willingness of employers to maintain benefits generally. This is especially true of smaller employers for whom these costs are substantially more significant.

Society will be harmed through an increase in the burden on the Social Security system which has in recent years undergone substantial strain. Benefit cutbacks and loss of savings will mean that employees reach their retirement years with less income available. They will increasingly look to the government, through the Social

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[2] The Treasury has also suggested that another $11 billion in revenue could be raised if §401(k) plans were eliminated entirely.

Security system and other welfare programs, to assist them in maintaining an adequate standard of living in their retirement years. Given the demographic shifts in population that are occurring, this burden will be difficult and expensive to maintain. The government should be increasing the reliance on the private pension and welfare system, rather than diminishing the incentives for that system.

Further, capital formation will be undermined. Private welfare plans constitute the largest source of private capital in the United States. Private, state and local governmental plans have assets exceeding $1 trillion. Private employer savings plans alone have assets in excess of $200 billion and the private employer system has assets of $700-$800 billion. This provides an important source of capital for the economy. Undermining the growth of this capital source could produce long-term adverse economic consequences to the country through a loss of adequate capital supplies in the future.

In summary, it is not necessary or appropriate for Congress to include in Treasury II the employee benefit proposals outlined above. Employers, employees and society generally would be harmed through further major employee benefit legislation at this time, especially proposals such as this that have not adequately been evaluated and that will not adequately be evaluated if included as part of a major tax reform proposal.

AALU would like to focus more specific comments on two employee benefit proposals in Treasury II that are particularly objectionable: the proposals restricting (and eliminating, in many cases) section 401(k) cash or deferred plans (CODAs), the proposals imposing penalty excise taxes on retirement distributions in excess of specified amounts, and the proposals relating to the imposition of new discrimination standards for employee welfare plans.

2. Section 401(k) cash or deferred proposals should be rejected.

a. *Proposed limits.*—Treasury II proposes an $8,000 limit on elective contributions to a CODA. That $8,000 would be reduced by any IRA contribution (and possibly spousal IRA contributions as well) made by the individual so that the $8,000 limit is, for many individuals, in effect a $6,000 limit. In addition, in calculating the elective contribution limits for the prohibited group (as redefined), the limits would be calculated on an individual, rather than an aggregate basis. Thus, one prohibited group member would not be allowed to make up for elective contributions not made by another prohibited group member (as under current law), even though on an overall basis the plan clearly would be non-discriminatory. Other CODA changes are also proposed that would have a restrictive effect on these plans.

Treasury II offers two justifications for these proposals. First, it suggests that CODAs are unfair because not all employees are covered by CODAs. Second, Treasury II suggests that an "excessive disparity" is permitted between the elective contributions of highly compensated employees and the elective contributions of other employees. More fundamentally, however, Treasury II evidences a preference for IRAs over CODAs. While CODAs are being restricted as a form of savings retirement vehicle, IRAs are being expanded. This choice is unfortunate.

b. *CODA's superior to retirement plans.*—Treasury II suggests that there is disparity in the availability of CODAs on a non-discriminatory basis and that there is lack of uniformity of coverage. Yet, at the same time, it proposes to expand IRAs, which are not even subject to non-discrimination requirements and which discriminate more than CODAs. Clearly, Treasury II would be improved if the emphasis were placed on improving CODAs rather than expanding IRAs.

While employer plans cover between 60% and 80% of the workforce, IRAs cover only 17%. CODAs are subject to rules that make them available on a non-discriminatory basis, whereas IRAs are disproportionately used by higher income individuals.

While precise figures are not available, it is known that over 40 of the 50 largest companies in the country have adopted CODAs. Therefore, their availability to employees will be wide-spread. Treasury II appears to overlook the fact that CODAs are qualified plans subject to all of the non-discrimination and coverage rules that have been developed by the Internal Revenue Service over an extensive period of time. This is a major difference and one that should not be dismissed. IRAs have none of these special rules and, consequently, any proposal emphasizing IRAs over CODAs is inherently defective.

c. *Premature to change rules.*—Much of the attack on CODAs seems to be based on the fact that withdrawal is permitted under limited circumstances during employment, i.e., that the plans can be used as savings (as contrasted to retirement) vehicles. Yet, at the same time, there is no data available on how much is actually withdrawn during service. As a consequence, it is premature even to consider revising the rules on CODAs for this reason. Many employers, in fact, have experience indicating that very few in-service withdrawals are made. Employees, while they are psychologically very concerned about the ability to make withdrawals, do not, in fact, often make them. Younger employees especially are concerned about accessibility of their savings. If they feel that they can reach the money when necessary, then they are much more likely to increase their savings. The emergencies that concern them often never arise. The net result, then, is that they have, in fact, saved for retirement through CODAs when they might otherwise not have done so.

d. *Contributions will be cut back.*—Both the proposed $8,000 CODA elective contribution limit and the redefinition of the ADP test and the recalculation of the limits for highly compensated employees are objectionable because they in effect will reduce CODA contributions. While arguably the limits will more directly affect the more highly compensated employees, there can be little doubt that the overall effect will be a reduction for all employees, including middle and lower income employees as well. Since higher paid employees would only generally be allowed to make a $6,000 elective contribution to the CODA and would not be allowed to make up for other contributions not made by other prohibited group members, the employer contribution formula (e.g., a matching formula) may well be adjusted downward to reflect the reduced savings incentive available. This ratchet-down effect would be directly detrimental to the retirement savings of lower and middle income individuals.

In addition, the loss of incentive provided by these plans will cause employers to stop offering them because the benefits do not outweigh the administrative cost of their maintenance. CODAs are often more expensive to maintain than other qualified plans and employers will only be willing to absorb this cost if the incentives available justify the administrative cost. Employers may well decide that with substantially reduced incentives, the complexity and administrative cost outweigh the benefits. This will, of course, remove a major savings opportunity for lower and middle income employees.

e. *IRA offset difficult to administer.*—As proposed, the $8,000 limit would be reduced by the IRA contribution made by any individual. The mechanical problems created by this IRA offset are numerous and unjustified. Employers do not have any direct knowledge of whether or when an individual makes an IRA contribution. Employees can make IRA contributions after the close of a taxable year up to April 15 of the following year. Thus, an employer whose plan meets the necessary ADP test may not even be aware that an employee has made a contribution. The employee may not even understand the effect of making an IRA contribution. IRAs should continue to be available in a manner that is unrelated to the retirement plan contribution made through employer sponsored plans. Any such tie-in creates enormous complexity.

f. *Adequate limits already exist.*—Since CODAs are qualified plans subject to the rules for qualified plans generally, they are subject to the contribution limits under section 415 of the Code and the deduction limits under section 4040 of the Internal Revenue Code. The plans are also subject to the same non-discrimination rules to which pension and profit sharing plans are generally subject.

These rules provide adequate limits for CODAs since they ensure non-discriminaiton and that contributions will be within the range allowed by Congress for employees generally. Establishing different limits will only create more complexity without serving the goals of uniformity, simplicity and consistent overall retirement savyings policy. Existing limits are adequate and should not be made more complex for CODAs.

g. *Discrimination against tax-exempt employers.*—The employee benefits proposals in Treasury II would eliminate the availability of CODAs to tax-exempt employers. Tax-exempt employers should be able to offer the same types of retirement programs that taxable employers offer. Otherwise, they are put at a competitive disadvantage in attracting and holding employees. Treasury II proposes to permit tax-exempt employers to provide an unfunded arrangement for employees comparable to that available for state and local associations (under section 457 of the Internal Revenue Code). This type of program is simply not an adequate substitute.

If the concern is the provision of qualified retirement plans by governmental entities, Treasury II can clearly make a distinction between governmental entities and private employers. To make that distinction between taxable and non-taxable employer is unjustified. Taxable and non-taxable employers have to compete in the same employee market and generally are allowed to offer the same types of qualified plans. If Congress feels that it is appropriate to establish different rules for governmental entities because of the different nature of those entities, then it can do so without mixing all tax-.exempt employers into the same category as governmental entities.

h. *Change in eligibility rules.*—The CODA proposals include a provision that would require employees to be eligible after one year of service. CODAs are currently subject to the same eligibility rules as all other qualified plans, that is, they can either use a one-year or a three-year eligibility period, depending upon the vesting schedule.

It is inappropriate to change the eligibility rules for CODAs. If profit sharing plans generally are permitted to have 100 percent vesting and exclude employees from participating for three years, then the same rules should be applicable to profit sharing plans which are CODAs. There is no rational justification for permitting one type of profit sharing plan to have a three-year waiting period for eligibility and another to only have one-year eligibility.

3. There is no viable justification for an excise tax on distributions above $112,500.

The President's Proposals would impose a 10 percent excise tax on annual distributions that exceed 1.25 times the defined benefit dollar limit in effect for the year under section 415(b) of the Internal Revenue Code. Currently that dollar limit is $90,000 so that the 10 percent excise tax would apply to annual distributions in excess of $112,500 ($90,000 x 1.25). The tax would apply to all tax-favored plans, including qualified plans, IRAs and tax-sheltered annuities. As part of this proposal, Treasury II would eliminate the overall contribution and benefit limitations in section 415(e) of the Code, except for loans that are top-heavy.

Treasury II offers two principal justifications for this proposal. The first is that by eliminating section 415(e) for all plans other than top-heavy plans, there is a reduction in complexity. Second, the Treasury notes (and this is really not a justification) that under current law there is no effective limitation on benefits from defined contribution plans.

a. *Treasury II justifications are faulty.*—The excise tax on distributions over $112,500 is justified under the Treasury II rationale in large part because there are no benefit limitations on defined contribution plans. This ignores the fact that there are specific contribution limitations on defined contribution plans while there are specific benefit limitations on defined benefit plans. These limitations were developed and modified by Congress over the last 11 years and presumably represent a statement of the amount of contributions and benefits permitted in a tax-favored qualified plan. It is inappropriate to impose special limitations on distributions from plans to which the contribution was limited.

Treasury II also indicates that a reduction in complexity will result from these proposals. This ignores two critical facts. First, the elimination of section 415(e) is more superficial than real. Because the limitations are maintained for top-heavy plans, most plans in the country will continue to be subject to or concerned about the overall limitations of section 415(e). Seventy to eighty percent of plans in the United States are maintained by small employers, many of which are top-heavy. As a result, the partial removal of section 415(e) by Treasury II will not produce a substantial reduction in complexity. Second, additional complexity is introduced through the excise tax since individuals will have to plan for and compute the excise tax and further complexities result if multiple beneficiaries are receiving death benefits from a plan.

b. *The excise tax is a form of age discrimination.*—Under IRS rules, if an individual works past normal retirement age, the number of years over which his retirement benefits can be paid out is shortened. The determining factor is the individual's life expectancy under mortality tables. As a result, the annual amount of the distribution increases with each year that the individual continues to work, not only as a result of continued contributions but also as a result of having a shorter period of time over which to receive the benefits.

The result of these rules is that an individual may, in effect, trigger the excise tax simply by working longer. Since most plans do not permit distributions until an individual actually terminates employment (consistent with IRS requirements) the individual may, in order to avoid this excise tax, be forced to terminate employment and begin receiving benefits. This is contrary to the policy of the Age Discrimination and Employment Act of permitting older employees to work without penalizing them for doing so.

c. *The excise tax eliminates neutrality as to the form of benefit payout.*—Payment of retirement benefits in annuity form is desirable for many individuals. Other individuals, however, may have more specific uses for their retirement income and might prefer a shorter payout such as an installment or a lump-sum. Because individual situations vary, the tax system should not unduly favor one form of distribution over another, but leave that decision to the individual.

The Treasury II excise tax departs from the neutrality principal and strongly encourages annuity distributions. An individual who takes a lump-sum distribution will be penalized even though, had that individual taken that distribution in annuity form, no excise tax would have been paid. This not only loses sight of the neutrality that should be observed by the tax code, it also overlooks situations in which individuals may, through hardship, disaster, medical emergency or otherwise, have an immediate need for money.

d. *The excise tax is unfair.*—Over the last 11 years, Congress has crafted detailed rules limiting the contributions to defined contribution plans and the benefits that may be paid out from defined benefit plans. These rules were designed to achieve parity between the two types of plans. In establishing the limits on contributions to defined contribution plans, Congress recognized that there is a tax-deferral element contained in defined contribution plans.

The Treasury II excise tax would depart from that parity and penalize defined contribution plans that have had successful investment performance. There is no justification for limiting both the contribution and the benefits from defined contribution plans and for penalizing employees in plans that have achieved successful investment performance and not penalizing employees in those plans that have had subpar investment performance.

e. *The excise tax affects middle income taxpayers.*—Because the excise tax does not apply to annual distributions below $112,500, an initial reaction may be that the penalty tax only applies to high income individuals. That is not the case. Many middle income individuals over their working lives accumulate benefits in excess of $112,500. If such individuals were to take their benefits in a lump-sum or over a relatively short period of years, the proposed excise tax would apply. If those individuals work past normal retirement, they may not, in fact, be able to avoid the excise tax.

In addition, if current practices are continued, the $112,500 amount will continue to shrink relative to the value of the dollar. The formula used in Treasury II is tied to a dollar amount in the Internal Revenue Code that has not been increased for inflation for many years. While the amount is scheduled to be adjusted for cost-of-living increases starting in 1988, in the past Congress has deferred allowing any such increases. If this pattern is continued, the excise tax will affect an even greater spectrum of taxpayers.

f. *The excise tax may cause a reduction in plan contributions.*—Often plan contributions by an employer are geared to the benefits available to the higher income employees. Becasue of the non-discrimination rules, lower income individuals generally receive the same percentage of contribution as a higher income individual. If, however, higher income individuals become subject to this excise tax, employers may reduce contribution levels because the net effective tax rate on plan contributions may be higher than the effective tax rate of paying the high income individual the amounts directly as compensation (or as unfunded deferred compensation).

For example, an extra $10,000 of contribution for an individual into a profit sharing plan might, under Treasury II be subject to tax at a 45% rate on distribution. If, however, the same individual were to receive the $10,000 directly as compensation then the maximum rate would only be 35%. Thus, a disincentive to make further contributions for high income individuals results.

This disincentive to make further contributions for the high income individuals may produce a "ratchet down" effect that will reduce the contribution for lower income individuals as well. The employer may simply reduce the overall contribution rate to the plan to adjust to the contribution rate that maximizes the tax benefit for the high income individuals. Thus, by imposing an excise tax on these distributions, the employer may reduce the contribution level for the plan in its entirety, thereby reducing the retirement benefits of middle and lower income individuals.

g. *The excise tax is complex.*—The excise tax creates a set of complexities that are contrary to the goal of tax simplification. Initially the individual must be aware of, plan for and compute the excise tax. Merely having to plan to avoid the excise tax will create substantial complexity for many individuals. Further, in the case of benefits paid to multiple beneficiaries after a participant's death, there will be significant coordination problems. One beneficiary may take a different payment form than does another beneficiary. Questions will arise whether the acceleration of payment by one beneficiary could cause the imposition of an excise tax on another beneficiary. For example, if Child A takes death benefits in a lump-sum and Child B takes death benefits over five years, can Child A's election impose an excise tax on Child B?

h. *The excise tax should be deferred and studied further.*—From the foregoing it is clear that the excise tax is much more complicated than it appears. It may have far-reaching effects in plan design and retirement security that have not been fully explored or appreciated. Further, Congress will, in the enactment of this major tax reform proposal, be concerned with broader issues and will simply not have time adequately to study the full effects of this proposal. The excise tax should not be enacted as part of the tax reform proposal, especially since it does not achieve simplification or contribute to the revenue necessary to achieve simplification.

Treasury II proposes the addition of uniform non-discrimination rules for insured and uninsured welfare plans. Many of these programs are already subject to non-discrimination rules currently. The purpose of the proposal is largely to make the rules the same for each type of benefit even though the benefits themselves may already be subject to specific non-discrimination rules. Health benefits and disability benefits are, however, not currently subject to non-discrimination rules.

The Treasury II proposals would accomplish this uniformity through a number of specific changes:

1. A new, uniform definition of the prohibited group members would be provided.
2. Uniform coverage rules would be added that would not allow coverage of the prohibited group to an extent greater than 125% of the coverage of the non-prohibited group.
3. A concentration test would be applied that would limit the amount of benefits available to the top 20 prohibited group members.
4. A new non-discriminatory availability test would be added.
5. A new non-discriminatory benefits test would be added.

Treasury II indicates two essential reasons for this proposal. First, it states a desire for uniformity of non-discrimination rules. This basically is intended to bring together the different sets of non-discrimination rules applicable to plans. Second, Treasury II indicates a strong desire to impose non-discrimination standards on all types of tax-favored welfare benefits as the "price" for the tax-favored benefits.

1. These requirements are unnecessary.

The uniformity proposals in Treasury II may have superficial appeal but as a factual matter they are not necessary. Non-discrimination rules already exist for substantially all of the welfare benefits that would be covered under this uniformity rule. For health insurance, the major welfare benefit not covered by non-discrimination rules. Labor Department statistics indicate that approximately 96% of all full-time employees of medium and large companies already have coverage. Disability coverage is also generally wide-spread in medium and large companies.

Thus, non-discrimination rules already apply to most of the benefits that would be covered by this proposal and those benefits not currently covered by non-discrimination rules are generally available to a very broad segment of the working population. As a result, there does not appear to be an substantial abuse of non-discrimination rules that would be corrected by the adoption of this uniformity proposal in Treasury II.

2. Welfare benefit coverage would not be expanded by this proposal.

Existing data indicates that companies that do not provide health and disability benefits do so for non-tax reasons. Many small companies, for example, simply do not have the financial resources to provide these types of benefits. In other cases, employers are unwilling to make long-term commitments to these types of benefits. In other cases, employers are unwilling to make long-term commitments to these types of benefits, recognizing that they may not be able to afford them in the future. In medium and large companies, the benefits are, as previously noted, already widespread. Thus, the adoption of uniform non-discrimination rules will not expand the provision of those benefits and therefore will not enhance the welfare of the working population.

3. Uniformity rules will reduce benefit coverage.

The net effect of the adoption of these uniformity standards will be counterproductive. Welfare benefit coverage of employees will decline, rather than increase, as a result of these rules and that decline will be felt most severely by lower and middle income employees. Implementation of these proposals will increase employer cost. This increased cost, especially for smaller employers, will provide a further disincentive to the provision of benefits or a desire to recoup these added costs through a reduction in the benefits provided.

The uniformity proposals also are unnecessarily mechanical and rigid. A number of business transactions, such as mergers and sales, will encounter substantial complications in complying with these new rules and will be unable to obtain IRS clearance in time to carry out the merger. In many cases, the net result will be a loss or reduction of benefit coverage. Plans will be reduced to the lowest common denominator rather than allowed to remain at higher levels, for fear of violating these rules.

4. The uniformity proposals discriminate against small employers.

Smaller employers will be discriminated against by these uniformity proposals. First, the added cost of these proposals will be a greater burden for smaller employers and the complication will be more difficult for the smaller employers to deal with. As a result many smaller employers will, as they have done in other analogous situations, reduce or cease providing these types of benefits.

Second, the proposed concentration test would severely discriminate against smaller employers. Many, if not most, of the employees of small employers may be in the 20-employee prohibited group under the proposed concentration test. As a result, it may be difficult or impossible for a small employer to comply with the concentration test. The net result is that small employers will not be able to provide the same tax favored benefit that large employers can provide. This will put smaller employers at a competitive disadvantage in hiring and retaining employees.

5. Uniformity proposals are too mechanical and inflexible.

Larger employers operate on a nation-wide or international basis. Benefits are generally tailored to fit geographic, demographic and occupational differences among the employees. These differences, in effect, reflect the governing market forces. Benefits are provided in accordance with the benefits available in the competitive geographical region. Small rural areas are not comparable to major urban areas in the types of benefit provided. Further, many companies continue to provide benefits on an historical basis. That is, subsidiaries are acquired from previous independent businesses and those subsidiaries continued to provide the types of benefits previously offered.

Forcing all employers into uniformity standards would not recognize these justifiable reasons for disparity. The rules would substitute a mechanical test in situations where such a test will lead to unfair and inappropriate results. More flexibility is needed in any type of non-discrimination standard that is applied so that companies can more realistically adjust for geographic, demographic, historic and other differences. Treasury II itself recognizes that there are mechanical problems inherent in these proposals and suggests that relief will be provided for certain specific types of transactions such as sales. However, experience has shown that it may be many years before such relief is provided and the relief may be totally insufficient when it finally made available.

The net result will be chaos in the provisions of welfare benefits. Because the non-discrimination rule essentially accomplishes nothing it should not be substituted in lieu of the more flexible rules that currently exist and that currently provide sufficient coverage.

6. Uniformity rule does not contribute to revenue gain and requires further study.

Treasury II indicates that the uniformity proposal does not raise any significant amount of evenue. Further, it is clear that there are enormous complications and problems with this proposal. Since the proposal is not necessary to the enactment of Treasury II and clearly requires more detailed examinaiton of its effects, it should not be included as part of Treasury II. More time is needed to develop consistent, harmonious retirement and welfare goals that are not driven purely by tax revenue. Enactment of these proposals would be premature and inadvisable.

I thank the members of the Committee for their attention and will be happy to answer any questions you may have.

STATEMENT OF ALAN PRESS, TRUSTEE, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, WASHINGTON, DC

The CHAIRMAN. Mr. Press.

Mr. PRESS. Mr. Chairman, and members of the committee, my name is Alan Press, and I am a trustee for the National Association of Life Underwriters. Thank you for this opportunity to express our concern over the Reagan tax reform proposal and the modifications to it recommended by the staff of the Joint Committee on Taxation.

We have submitted a detailed statement on the Reagan plan. We request that you include it in the record.

Here I will focus only on some of the modifications proposed by the Joint Committee on Taxation staff.

Our primary concern continues to be the proposed tax on annual increases in life insurance cash values. We appreciate the joint committee staff recommendation against a current tax on cash values, and hope that the Ways and Means Committee will accept that recommendation. We also urge you to support it.

The importance of retaining current tax law on life insurance product taxation cannot be overstated. Cash values are not income, as defined under accepted tax principles. They are a function of the level premium structure of permanent life insurance, and accumulate to become the death benefit. If a policy is surrendered, its cash values are transformed into investment income. At that point, that income is already taxable under current law. Until and unless the policy is surrendered, however, its cash values are not income actually or constructively received.

Further, a current tax on cash values would be discriminatory against older people. The older the policy and the policy owner, the greater the taxable income. In fact, for many 55 and older people, life insurance taxable income would exceed annual premiums. This defeats the purpose of the whole life structure, that is, making life insurance affordable even at older ages.

Current tax liability on cash values would seriously dampen the public's ability and willingness to buy adequate amounts of permanent insurance protection. It would result in an underinsured population. Could the Federal Government pick up the tab for caring for the resulting increase in unprotected families and retired people?

Of just as much concern to us is the joint committee staff attack on policy loans. The JCT staff proposal would disallow the deductibility of all interest paid on policy loans. It would also severely restrict policy borrowing by causing loan proceeds to be includable in taxable income on a LIFO basis unless total loan balances were $50,000 or less and repayment occurs within 5 years.

First, it is unconscionable that loans against life insurance policies are singled out for draconian tax treatment. It is also inappropriate, given the time, energy, and other resources expended between 1982 and 1984 when this issue was debated during the process of enacting the Stark-Moore life insurance tax law. Borrowing from life insurance on a tax-neutral basis relative to other assets is critical to a policyholder's ability to commit to an adequate long-term insurance program. The JCT staff proposal must be rejected.

We urge you to reject all proposals to impose new income tax liability on employer-provided plans, including section 401(k) plans. Such new taxes proposed to pay for rate reduction only transform visible tax liability into a hidden tax.

In conclusion, the provisions we are concerned about deal with some of life's greatest problems—death, illness or injury, retirement, and financial emergency. The Reagan tax proposal eliminates none of these problems, yet it makes all of them harder to solve. Reform implies improve. This proposal changes visible taxes to hidden taxes. It fails the test of fairness, simplicity and economic growth. In short, the Reagan plan does not meet the definition of true tax reform. Thus, if this plan is what the reformers mean when they call for tax reform, we oppose it.

Thank you. We will be happy to respond to any questions.

[The prepared written statement of Mr. Press follows:]

STATEMENT OF

THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

BY

ALAN PRESS, CLU

MEMBER, NALU BOARD OF TRUSTEES

ON

CERTAIN INSURANCE-RELATED PROVISIONS

OF

THE PRESIDENT'S

TAX REFORM PROPOSAL

TO THE

COMMITTEE ON FINANCE

U.S. SENATE

OCTOBER 1, 1985

Mr. Chairman, members of the Committee, I am Alan Press, a Trustee of The National Association of Life Underwriters. NALU represents 133,000 career life and health insurance salespeople who have daily personal contact with the literally millions of taxpayers who make up the life insurance-buying public. In our opinion, our millions of clients as well as the 133,000 life and health insurance agents we represent would be severely disadvantaged by the Reagan Administration's tax proposal in its present form.

We are concerned about several features of the Reagan proposal. In addition to one of the most destructive of the proposal's features, the plan to tax as income the increasing cash value buildup within life insurance policies, we oppose the Reagan plan's proposals to include some portion of employer-provided insurance in employees' income; to limit the deductibility of consumer interest; to eliminate or limit §401(k) plans; to change qualified pension plan rules; to impose a harsh uniform discrimination rule; and to change the tax law governing life insurance companies.

First, let me comment on the proposal to subject to current tax liability the annual increases in life insurance policy cash values.

I. Cash Value Tax.

As we understand the President's plan, a policyholder would include in interest income for a taxable year any increase during the taxable year in the amount by which the policy's cash surrender value exceeds the policyholder's investment in the contract. A policyholder's investment in the contract would be equal to the aggregate of his or her gross premiums, reduced by the aggregate policyholder dividends and other distributions under the policy and by the aggregrate cost of renewable term insurance under the policy. This would mean that for the first time owners of life insurance policies would be treated as being in constructive receipt of the cash value of their policies.

I think, Mr. Chairman, that the history and development of cash value life insurance needs to be reviewed and understood in considering whether an income tax on cash value is justified.

Function of Cash Value. Cash value life insurance developed out of the desirability if not the necessity of providing a level premium for the duration of a life insurance contract. The vitality of the level premium has been described as follows:

> "The chief significance of the level premium concept lies in the fact that the redundant premiums in the early years of cash value contracts create a fund which is held by the insurer for the benefit and to the credit of the policyowners. Earnings (principally interest) are produced by investing the fund. The accumulated fund, improved by earnings, is used to pay out the benefit amounts provided for under the contract. Thus, the level

> premium is the only arrangement under which it is possible to provide insurance protection to the uppermost limits of the human life-span without the premium per unit of face amount increasing as age advances and eventually becoming prohibitive for most individuals." [Life and Health Insurance Handbook, 1973]

The cash value of a policy therefore has its origin in the excess premiums charged in the early years of the contract to keep the premium level over the life of the policy.

In fact, it used to be that policies contained no provision at all for the payment of amounts representing an insured's equity on termination prior to the maturity of the policy. The law did not generally require policies to have a cash value until after the turn of the century. Cash values are not 'savings' or 'investment' in concept, but rather they grew out of public policy against full forfeiture upon lapse and the desire to establish a basis whereby the purchaser, on early termination, could recover some of the payments already made. However, unless and until surrender occurs, the policy's cash values represent a continuing accumulation of death benefit.

On this point, we draw to your attention the legal analysis of the Treasury's proposal to tax currently cash value accumulations. This Congressional Research Service study, prepared by Robert B. Burdette and released June 11, 1985, points out that the Treasury proposal raises important legal due process questions. As Mr. Burdette indicates, cash values are an accumulation of death benefits, at least until the policyholder transforms them into investment by surrendering all or part of the future death benefit and concurrently receiving the cash value attributable to that amount of foregone death benefit. As you know, under existing law this action -- the withdrawal that transforms cash values from death benefit to 'investment -- triggers a taxable event governed by laws and regulations which were studied in depth during the writing and enactment of the 1984 life insurance tax act.

As Mr. Burdette phrases it,

> "In the situation where the proposal results in an over-inclusive measure of taxable income (i.e., where it requires "too much" to be included in a policyholder's gross income by requiring that policyholder to include amounts never actually received), the over-inclusiveness derives from the application of a fiction of law. According to that fiction, every year the policyholder is presumed to receive the net increase in inside buildup for that year regardless of whether or not the policyholder actually ever receives it. In effect, the proposal presumes that every policy is eventually surrendered. Obviously, everytime a policy matured, that presumption would be contradicted by fact. The factual wrongness of the presumption in such instances and the consequently perceived legal "wrongness" of (i.e., "injury" worked by) imposing a tax burden on the basis of such a faulty presumption raise fundamental due process concerns." ("A Legal Analysis of the Treasury Department's Rationale for Its Proposed Method of Taxing the So-Called 'Inside Buildup' under Certain Life Insurance Contracts," Congressional Research Service, Library of Congress, Robert B. Burdette, Legislative Attorney, American Law Division, June 11, 1985, pp CRS-34,35)

Nonetheless, in an ancillary sense, and because some policies are terminated prior to death (most often at retirement), the cash value buildup of a permanent life insurance policy has long since been recognized as serving a socially-desirable savings and investment function. Thus, in addition to providing a means whereby level annual premium products can stay in force at the upper ages, and a mechanism for the orderly accumulation of death benefit, cash values sometimes are transformed into a form of savings.

It is true that the savings aspect of permanent life insurance engenders benefits in addition to the primary benefit of life insurance -- the preservation of the economic human life value of the insured for his or her beneficiaries. The cash value element of life insurance also affords purchasers additional valuable features like policy loans, automatic premium loans, and extended term insurance to prevent lapse, as well as the right to purchase annuities in accordance with policy settlement options. Such settlements are, of course, taxed as received under current law. In addition to providing a guaranteed face amount, the cash value life insurance policy has thus evolved into a contract embodying a significant bundle of complementary policyholder options, none of which can really be said to predominate in importance over others, but all serving important needs at various times.

This Would Be An Age-Indexed Tax. The operation of the cash value tax would work harshly against older policyholders. As the years pass, annual cash value increases become larger. As policyholders age, the cost of term insurance protection (which decreases the "investment" that offsets taxable increases in cash values) increases dramatically. The end result would be much greater tax liability during a policy's later years. Thus, the very purpose of "whole life" insurance -- viz., the employment of a level premium structure to keep life insurance affordable at older ages -- would be be undone by the imposition of a tax that would have the effect of making the policy more expensive every year.

The tax obligation imposed on a policy under the Reagan plan could indeed exceed the premium as the policyholder nears retirement age! For example, a $40,000 whole life policy, with a level annual premium of $535, issued to a 35-year old male, would generate taxable income of $1,098 at the policyholder's age 55. By age 75, the same policy would generate taxable income of $1,644. In fact, industry actuaries have estimated that the average policyholder would pay some $10,900 in additional taxes over the policyholder's lifetime if the Reagan proposal to tax cash values were to be enacted.

Cash Values Hedge Against Social Security Overexpansion. Life insurance, both temporary and permanent, plays a most vital role in meeting the income security needs of people, and by doing so reduces the pressure on the Social Security system to provide ever higher and broader levels of benefits. Both permanent and term insurance provide benefits for survivors of breadwinners. Only permanent forms of insurance, however, provide survivor benefits at more advanced ages, as well as retirement benefits for breadwinners at retirement.

In view of the troubled financial state of Social Security during the last decade, this is not the time, in our judgment, to do anything to discourage people from acquiring permanent insurance. The decisions that might be made today which would have that effect won't show up as adverse results for many years. And the Congress knows only too well the difficulty of projecting the future financial position of Social Security, try as it might. If, as some Social Security experts suggest, long-range projections are off by only a small percentage, huge shortfalls in revenue may result.

Private funds may then be the only bulwark against future Social Security benefit increases. It would be catastrophic if tax policy-induced cutbacks in the retirement benefits of permanent insurance began showing up at the same time.

Cash Values Are A Source of Capital. Taxation of the increasing cash values of life insurance would also depress a proven source of needed investment capital. In 1984, life insurance companies provided more than $64 billion for investment in the economy of the country.

To walk through a life insurance company's investment department is to walk down the Main Street of most cities and towns in America. The telephone wires reflect investment in utilities; the shopping mall with its dozens or hundreds of jobs well might be financed at least in part by mortgages held by life insurance companies; housing construction is made possible through resources held by life companies. Life insurance company assets at work are reflected in corporate bond investments of well over $200 billion; mortgages of almost $150 billion; and corporate stocks in excess of $40 billion.

These primarily long-term investments are made possible because millions of policyholders are willing to commit themselves for long periods of time to cash value life insurance. According to the Life Insurance Fact Book of the American Council of Life Insurance, life insurance ranks in the top five among private domestic institutional sources of funds, supplying close to 8% of the total funds flowing into financial markets.

Taxation of funds attributable to policyholders would surely dilute this pool of capital to the extent that the tax would discourage the purchase of cash value insurance because, as compared with term insurance, substantially all of the investment capital derived from premiums comes from cash value life insurance premiums. The American Council of Life Insurance (ACLI) -- made up of 572 life insurance companies -- has said that, "Term insurance premium availability for investment is negligible." [ACLI Submission to the Secretary of the Treasury, W. Michael Blumenthal on a tentative Carter Administration Proposal to Tax Policyholders on the Interest Element of Life Insurance Contracts, Aug. 25, 1977, at p. 5]

If you don't think taxing cash values represents a real threat to capital formation, let me point to the experience of our neighbors to the north. Loss of the deferral of taxation on annuity investment yields -- which the Reagan plan also proposes to tax -- would probably decrease the use of annuities drastically. Certainly this occurred in Canada when, in 1982, the Canadian tax law was changed to allow tax-deferred annuity income buildup only to the extent annuities are "registered accounts" (roughly the same thing as our IRAs). Sales dropped by 50% from 1981 to 1982, and are still dropping. The full impact of the loss of this important retirement planning tool will be felt in years ahead as capital for investment is thus depleted and more and more inadequately-protected working people retire on insufficient retirement savings.

There Is No Constructive Receipt Of Cash Values. Under present law, amounts credited to the cash value of a life insurance contract are taxed only when withdrawn, and only to the extent the withdrawals exceed the aggregate premiums paid by the policyholder for the contract.

Thus, cash values are not current income. Rather, they are merely a measure of an accumulation that the policyholder may in fact _never_ realize. Cash values are an accumulation that in most cases will remain only a beneficial interest. They are, in fact, part of the death benefit. Cash values become income only when all or part of the death benefit is foregone. It is a long-standing principle of tax law that income is not taxable until it is realized, either actually or constructively.

In the case of life insurance, the Tax Court held in _Theodore H. Cohen_, 39 T.C. 1055 (1963), that the taxpayer's right, prior to the maturity, surrender or sale of life insurance contracts, to receive the cash surrender value of those contracts, including periodic increments thereof, was subject to such 'substantial restrictions' as to make inapplicable the doctrine of constructive receipt. As you well know, this doctrine generally holds that income is taxable if there is no limitation or condition on the taxpayer's right to bring the income within his control, even if he does not actually do so. The court followed precedent to the effect that there is no constructive receipt of income -- hence no taxable income -- where one must surrender a valuable right in order to realize it.

Tax liability on the interest earned on cash values would thus run counter to the doctrine of constructive receipt, creating the inequity, in countless cases -- most of them involving millions of middle class taxpayers -- of imposing a tax on money never to be received. Most people would say that is is bad enough to have to pay taxes to the Government on income; but it would be unconscionable to have to pay tax on money you never get!

As noted in one prominent 1972 study examining the current tax treatment of the so-called "inside buildup" (which, incidentally, conceded that this treatment can be justified on social, legal and administrative grounds), the bulk of the advantage of the present tax treatment accrues to middle income families. [McClure, The Income Tax Treatment of Interest Earned on Savings in Life Insurance, Joint Economic Committee Print, 92 Cong., 2d Sess., May 8, 1972, at 370]. It should not go unstated that the middle income wage earner presently bears an increasingly heavy share of the federal tax load and to impose additional taxes on a means of protecting his or her family against premature death would be unjust in the extreme from both a social and economic standpoint.

Analogous Purchases Are Not Taxed. On the question of whether various types of permanent life insurance products should continue to enjoy historical tax-free treatment, your Committee might consider the analogy that exists between cash value life insurance, and say, a diamond engagement ring, or a home.

Each has a "savings" or "investment" element or aspect to it, which usually shows considerable enhancement in value. But does this mean that the "inside buildup" in the value of the diamond ring should be taxed? Should the growing equity in the home be taxed?

We think that your answer in those instances would and should be "No". We think so because in each case there is no receipt of the enhanced accumulation by the purchaser; and we think so because of the presumed motivation for the purchase. Even though the ring and the home both have a well-recognized growing "inside" value, neither item was bought for that purpose, or perhaps even with that in mind. The ring was bought for marriage, the home for shelter. Likewise, a life insurance policy is bought for protection and security.

In our opinion, Congress would have to weigh carefully whether it is reasonable and socially desirable to tax the appreciation in one of these kinds of property without logically taxing the others; or whether, instead, each serves a sufficiently worthy social and economic purpose that its historical tax treatment should be left unabridged.

Revenue Impact Is Negligible. Deletion of the proposal to tax the inside buildup would have almost no revenue impact. According to Treasury Department figures, the proposal has no revenue effect at all until 1990, and then only $200 million.

Even Secretary Baker has testified that this proposal is driven by policy and has little or no revenue considerations attached to it. To the extent that the purchase of cash value life insurance policies is discouraged, then even in the out years when the liability on the policyholder is highest, the revenue collected by the government is likely to be very low.

The historical and social justifications for the tax treatment of the cash value in a permanent insurance policy remain persuasive. To the extent that a permanent life insurance policy is purchased to provide long-term protection, and so long as it can be characterized as property whose investment features, if any, are merely a byproduct, it should continue to receive the tax treatment presently accorded it.

The taxation of life insurance cash values, like all other life insurance issues, was thoroughly and thoughtfully debated during the complete rewrite of life insurance tax law that took place over the last three years. The newly-enacted "definition of life insurance," found in §7702 which was added to the Internal Revenue Code July 19, 1984, represents consensus among the Congress, Administration and industry as the most appropriate mechanism to avoid investment-oriented abuse of life insurance policies. It is unfair, inefficient and foolish to reopen this question when the agreed-upon solution -- in effect for just 9 months -- has not yet been tested.

II. Deductibility of Interest.

The Reagan tax reform plan proposes an annual limit on interest paid on debt not incurred in connection with a trade or business. The limit proposed is $5,000 ($2,500 for a married person filing a separate return), plus an amount equal to the taxpayer's net investment income. The interest paid on a mortgage on the taxpayer's principal place of residence would be exempted from this annual limit. Generally, the limit would be effective for interest expenses paid or incurred on or after January 1, 1986. Two transition rules allow a phase-in of fully limited interest deductibility.

Life underwriters oppose the idea of limiting the deductibility of interest on consumer loans. A limit on the deductibility of consumer interest would set up a tax-tilted competition among forms of debt. The limit would conflict with the major thrust of the Reagan tax reform plan, i.e., to eliminate tax-motivated transactions. We believe life insurance to be a necessity, like housing, and we believe it is perceived as such by the general public. It would be unfair to put home ownership at a tax advantage over other essentials, such as insurance, food and clothing.

This limitation would also encourage the restructuring of debt, so that the bulk of indebtedness would wind up connected with home mortgages. Restructuring of debt to take advantage of the principal residence "loophole" would clearly brand this part of the tax plan as consisting of form, not substance. Debt restructuring could be perilous to the country to the extent that it could lead to an over-abundance of over-mortgaged principal residences, which, in an economic downturn, would be widely subject to foreclosure.

Despite two transition rules, the interest limit will have a retroactive effect on existing debt and interest obligations. It is always unfair and could be harmful to change the rules on anyone in midstream. People who are relying on financial planning done in good faith under existing law could find themselves suffering heavy economic losses if this rule were allowed to be imposed retroactively. This is of particular concern to those who have financed life insurance plans.

With reference to life insurance, policy loans are often the only way people can keep needed protection in force during temporary economic hard times. It is during those same hard times that the limit on interest deductibility will be hardest to bear. Thus, the limit could result in loss of coverage and protection.

The right to borrow on a life insurance policy is often a major persuasive factor in the decision to purchase an adequate amount of permanent insurance. The basic appeal of life insurance is its long-term promise of financial security at retirement or in the event of premature death. In return, a sound life insurance program calls for a long-term financial commitment from the policyholder. Many -- in fact, most -- prospective policyholders can with comfort determine that the annual premium for the amount of insurance they need is affordable at the time of applying and in the foreseeable future. But they worry about the possibility of the times of financial hardship that can befall many of us. The ability to borrow from their policies in the event of those hard times becomes a key factor in their decision to make the long-term financial commitment that is necessary to the success of the program. And it is important to note that in many cases the sale is made because of the option to borrow, but actual borrowing may never in fact occur.

Any life underwriter could cite numerous examples of the near-daily working of the importance of the policy loan feature. For now, let one illustration suffice: consider a 35-year-old man who has agreed that he needs a $200,000 permanent life insurance policy. He believes he can afford it at present. However, he's less than certain that the premiums required will continue to be affordable for the 30 years or so that premiums will have to be paid before the major planned-for event, retirement, occurs. He is inclined to purchase only $100,000 of insurance at present, so that he can be more certain of the financial ability to keep the policy in force. But, armed with the knowledge that should those financial hard times occur he will be able to borrow from his policy, deduct the interest on the loan, and thus keep the policy in force, he is convinced to go ahead with the purchase of the entire amount of coverage he really needs.

In actual fact, this policyholder, like most policyholders, will borrow only minimally or not at all from his policy. And he will repay the loan. But the policy loan feature has motivated a decision that could not as safely have been made in the absence of that feature. Limiting the right to deduct interest would take away one sound reason for buying adequate permanent insurance.

Because the policy loan feature motivates the purchase of permanent insurance vastly more often than actual borrowing results, its limitation would act to depress much more than tax-leveraged borrowing. In the aggregate, such a limit would result in even more underinsurance in the population, creating greater potential for expensive government programs to fill the gap. This would also substantially reduce the inflow of capital to the nation's economy. With our national savings rate at only 6.1%, America can ill-afford any substantial reduction in capital-developing capacity. And the deficit-ridden federal budget cannot bear the cost of more social programs, or greater levels of benefits under Social Security. Yet, to the extent that this provision -- or any new tax law -- would act to inhibit the private sector's ability to provide financial security and capital formation, it would create the potential for just such pressure on the federal government.

The Reagan interest deduction limit would have other harmful effects. We believe it would stimulate lapsation of coverage among current policyholders who purchased life insurance contracts on the basis of the option to finance them. For these people, enactment of the proposal may present a choice between maintaining a policy they may not be able to afford without the deductibility of interest on policy loans, or surrendering their policies. This would be harsh indeed. For some, it would mean replacing existing contracts with lesser, perhaps inadequate amounts of permanent coverage. For others who may by then be uninsurable the result would be even worse. Those people would not have the option of buying less new coverage. Their choice would be limited to surrendering their financed insurance and living with an unmet insurance need, or somehow finding a way to pay the extra cost from other sources.

III. Taxing Employee Benefits.

The Reagan tax reform proposal suggests subjecting the first $120 or $300 of employer-provided health insurance to income tax. Administration officials -- including Treasury Secretary Baker -- concede that this "floor approach" has problems and say they would prefer a "cap approach;" i.e., a ceiling above which the value of one or more now tax-free employer-provided benefits would become subject to income tax.

Life underwriters question the wisdom of taxing employer-provided benefits either way. Whether a floor or a cap, or something in between; whether imposed on health insurance alone or on all basic employee benefit plans, there are many reasons why taxing employee benefits would be bad tax policy and bad social policy.

First, employer-provided benefits constitute a financial safety net that, in basic form, is vitally important to most working Americans. Second, few if any of the calls for increased tax fairness and/or simplicity contemplate imposing tax liability on working class Americans who already feel overburdened by the tax load. Third, employee benefit packages are an important element of overall compensation. Compensation that consists of salary-plus-benefits can usually be counted on to be superior to compensation that consists only of salary. Fourth, benefit packages provide flexibility in compensation plan design. Fifth, the imposition of tax liability -- partial or total -- on the value of employer-provided benefits would decrease -- and probably dramatically -- the level of protection in force, and thus also tend to increase the pressure to expand government and other assistance programs.

Taxing health insurance to employees would be a threat to what is now an effective and efficient health insurance system. To tax all or part of an employer-provided health care benefit would be to ignore that in well over half of today's families both spouses work, and both spouses are covered by employer-provided health insurance. This "double coverage" could generate a discriminatory tax liability, especially if the floor approach is enacted. One thinks of situations where tax would be paid by both spouses, but coverage for claims may only be available under one or the other plan.

Further, to the extent that employees -- especially younger, less well-paid employees -- incur taxable income, they may, given the choice, choose to reject health insurance coverage. This would pose a significant danger. Like the two-employee family, the comparatively young, healthy worker who opts out could upset the discrimination rule calculations. He or she could also contribute to adverse selection, the process that occurs when people who are unlikely to need the protection drop out of a plan, leaving those more likely to present claims. Higher expenses would then drive up costs, perhaps to a prohibitive level.

In this connection, one reason advanced by the Treasury for taxing employee benefits is that people with them are getting what the Treasury Department believes is a "free ride", vis-a-vis people without these benefits. But to tax those benefits would, as we have said, only cause people to drop out, and thus add to the rolls of people without benefits, only exacerbating the social problems associated with lack of coverage.

Each formulation of taxable health insurance has its own problems. A cap would discriminate against high-cost economic areas (e.g., New York, California) and certain groups of people (e.g., older work forces; predominantly female work forces; work forces in high risk occupations). A cap would discourage cost-effective coverages like preventive care, second opinions, and dental or vision care. A floor would add yet more tax weight on the backs of the working class, while serving public policy very little if at all.

Finally, the truth is, because 96% of all employees of medium and large size employers have employer-provided group health insurance protection, tax-free health insurance cannot in any justifiable sense be considered a "tax loophole serving a special interest." Nor can any threat to its continued viability be tolerated without real fear for the adverse consequences. As a practical matter, given the universality of health insurance protection, the Reagan proposal can be viewed only as a thinly-disguised tax increase, especially for middle income Americans.

IV. Section 401(k) Plans.

These retirement savings plans are growing increasingly popular among all sizes of employers, primarily because of employer matching contributions (only about 12% of the eligible people, by contrast, have IRA's). Section 401(k) plans are a form of defined contribution pension plan, and thus subject to the defined contribution plan annual contribution limit of $30,000 or 25% of compensation. Many organizations -- including NALU, itself a small employer -- exempt from tax under IRC §§501(a) and 501(c) maintain §401(k) plans for their employees. These plans are subject to strict nondiscrimination rules and early withdrawal restrictions.

The Reagan plan proposes to eliminate §401(k) or limit annual contributions to §401(k) plans to $8,000, minus the amount contributed to an IRA. This singles out the most popular of all defined contribution plans for repeal or for new, severe limitations. If the limit rather than repeal is considered, it would discriminate against those who have spousal IRAs, because their IRA contributions could limit their permissible level of contribution to §401(k) plans to half the amount that could be contributed by those without spousal IRAs. Also, coupling limits on §401(k) and IRA contributions -- the only such coupling in the pension planning area -- creates unnecessary complexity for no apparent justification, especially given the fact that only 12%

of the population have IRAs. Further, the proposal as drafted could create an administrative nightmare because $401(k) plan contributions are elected at the beginning of a tax year while IRA contributions can be made as much as 15½ months later. This timing disparity could cause monumental problems. In addition, the Reagan proposal would apparently prohibit $501(c)(6) trade associations like NALU from even having $401(k) plans. To the extent that many such organizations do not qualify for the other tax-favored retirement savings plans available to governmental and educational employers [$501(c)(3) entities], the proposal is discriminatory.

V. Qualified Plan Rules.

The Reagan proposal would "simplify" pension law by totally rewriting the technical distribution and contribution rules. Whether the proposed changes would in actual fact be simpler than current law is debatable. But any change as complex as these proposals is bound to add complexity, at least in the short run.

Generally, the Reagan plan would impose penalty taxes on early and late distributions, on plan terminations, and on "excess" payments received by a plan's retired participants. Setting aside the question whether these changes represent sound public policy, they would be the fourth set of major law revisions since 1982, and would represent yet another obligation on the part of employers to amend existing plans.

We believe patience with the unending stream of changes in technical rules governing qualified plans has virtually run out. Complexity that is in place and understood is preferable to changes that may or may not be simpler, but must be analyzed and implemented -- at substantial cost. There is a frightening and growing feeling among the clients of our members that the administrative cost of maintaining pension plans which have to be changed in a major way on a nearly annual basis outweighs many of the benefits these plans provide. This is particularly true in the case of small employers who must pay outside administrators for each of these changes, and for whom the cost per employee is much higher. And higher administrative costs limit the resources available for retirement benefits. Increasing resources used for administrative purposes is not a worthy social or economic goal.

The promulgation of further changes in these rules -- before we have had a chance to see if the current rules work -- will surely have a chilling effect on the establishment of new plans and the maintenance of existing ones.

VI. Discrimination Rule.

The proposed uniform discrimination rule is an attempt to apply one rule to all employers and all tax-free employer-provided benefits. However, this attempt at simplicity has sacrificed fairness. The proposal's suggestion that key employees never be allowed to receive more than 125% of the benefits provided other plan participants would make it impossible for a very small employer to provide benefits at all. An individual employee's decision to reject any given benefit -- an inescapable possibility if benefits become totally or partially subject to tax --could destroy a plan's ability to satisfy the discrimination requirements.

The carrot held out in the proposal that authority might be given to the IRS to grant waivers and impose alternative discrimination rules of its own design is anything but reassuring. From our perspective, the IRS has not been known for its timely, even-handed implementation of Congressional intent.

In short, _if_ a uniform discrimination rule is desirable, such a rule needs to be more definitive and at the same time more flexible and thus responsive, particularly to small employer needs, than the one described in the Reagan plan. To accept a rule such as this one would create the danger that employers with fewer than 25 or so employees may find themselves legislated out of the field of offering tax-free benefits to their employees.

VII. Company Taxation.

Finally, in addition to expressing our concern about the policyholder issues, we want to add our support to our companies' position on the provisions governing life insurance company taxation. While we, as representatives of agents, are not specialists in corporate tax law, we are responsible for evaluating corporate tax law's impact on the saleability of life insurance. To the extent the tax law influences the price of the life insurance product, it does affect saleability. Thus, we support our companies' evaluation of the life insurance reserve and special deductions proposals.

Conclusion

For the reasons I have outlined, life underwriters cannot support the Reagan tax plan. The proposal's adverse effects on our business and on the security of our clients would make the price for lower tax rates just too high to pay. From a life insurance perspective, the Reagan tax reform plan appears more complicated, more unfair, and would fall short of its goal of stimulating economic growth. Worse, it would severely damage our industry and the people it serves.

We do not believe this plan is truly "reform". "Reform" means to improve by change. This plan would not improve anything; it would, however, bring change which we feel would not be in the best interest of the insuring public.

In summary of our sentiment with respect to the Reagan plan, let me just say, Mr. Chairman, that if this is tax reform, we're against it.

Thank you. I will be happy to answer any questions you might have.

The CHAIRMAN. What is tax reform? Not what is it not, but what is it?

Mr. PRESS. Tax reform is making the Tax Code equitable for all taxpayers.

The CHAIRMAN. Is anybody here opposed to that?

Mr. PRESS. No.

The CHAIRMAN. No, I don't think so.

Mr. PRESS. I said if this is tax reform.

The CHAIRMAN. I understand that. I often have difficulty getting people to tell me what tax reform is. Very clearly what we are about to do to them, it isn't. I understand that. But I'm sure we all want to make it equitable. Let everybody raise their hands who want inequitable tax reform. [Laughter.]

I saw a hand go up back there. [Laughter.]

That's a facetious question. I apologize.

Mr. Deering, let me ask you this. Let's assume that the Congress were to go along with the administration's interest limitation, the $5,000 limitation, exempting, of course, the home mortgages. Tell me the justification in the investment income. Tell me the justification for exempting insurance loans from the limit, if we are going to include all other loans but homes.

Mr. DEERING. I think the justification, Mr. Chairman, is twofold. One, if we recognize life insurance as a socially desirable transaction because of all the reasons that have been stated here this morning, then I believe we are in a position where we should say let us give this a favorable tax treatment. Second, we are already, of course, under the proposal exempting residential loan interest. And the similarity between the purchase and ownership of a residence for the physical security of a family and the purchase and ownership of a life insurance policy for their financial security, is marked.

The CHAIRMAN. In the purchase of whole life insurance, I believe you were emphasizing.

Mr. DEERING. The purchase of whole life insurance because whole life insurance is the only product that guarantees the permanent solution. Term insurance has all of the problems I mentioned earlier. It becomes prohibitively expensive at the later ages. It does not create a fund under which premiums can be paid during the illness or inability of the policy holder to pay.

The CHAIRMAN. So in a nutshell you believe that life insurance loans ought to be exempt because as a matter of social policy the overriding good that they do by encouraging people to purchase whole life is infinitely better than the alternative of some kind of Government reinsurance or Government insurance to take up the slack.

Mr. DEERING. Correct.

The CHAIRMAN. Now you also mentioned in your statement that there is a great inducement to saving, the overall aggregate saving. You say whole life is an incentive to capital formation. And you wouldn't have that saving element as much in term.

Mr. DEERING. You would have almost no savings element for the elementary reason that the term policy does not accumulate any cash values. And what we are talking about is the investment of those cash values into the American economy.

The CHAIRMAN. I understand that. But what I am curious about is this: Congress, over the years, has tried a variety of devices to increase the savings rate in this country. We tried the all-savers certificates and we tried the IRA's. And everything we tried doesn't seem to work very much. The level of savings never got over 8¼ percent in the early 1970's. It was the mid-7th percent during the 1950's and 1960's. So everything we have tried to encourage hasn't worked very much. What would happen if people went to whole life and you didn't have the accumulated savings? What would happen to the money that otherwise would have gone into the pool of insurance savings? Wouldn't it go into some other form of saving?

Mr. DEERING. I don't think so.

The CHAIRMAN. Why?

Mr. DEERING. I think it would go into consumer expenditures because I think people tend to take off the top of their incomes that amount of money which they put into their whole life insurance. And if they are relieved of that devotion, let's say, I think the money which is left over will tend to go into the stream of consumer buying as opposed to consumer saving.

The CHAIRMAN. Why if the incentives we have tried to get people to save in the aggregate haven't worked all that well, if incentives don't work, why would this disincentive work to reduce savings? I heard what you said, but I don't see why the incentives don't work but the disincentives, in essence, would work.

Mr. DEERING. I think we are dealing now with a social phenomenon we don't know about. We know the incentives don't work because the percentage hasn't gone up. But are we prepared to lay a disincentive because what we may find is that while incentives don't work, disincentives do.

A good example might be that most of the personnel consultants will tell you that salaries do not motivate people, high salaries do not motivate people, but low salaries demotivate people. And I would suggest the same may be true here. Incentives may not work. I'm afraid disincentives will.

The CHAIRMAN. You may be right. And the frustration is nobody knows. You can have all of the Nobel Prize winning economists in this country come and testify and my hunch is they would not agree as to whether it worked or not, and we would not know as we went into it whether it was going to work or not.

Mr. DEERING. And is it a chance that we are willing to take.

The CHAIRMAN. Mr. Edward Phillips, let me ask you this: Assuming that you got rid of whole life, we changed the tax system and it wasn't any longer worthwhile. In addition to term insurance, which you would have to shift to, what other changes would you see in the terms of the kinds of products you sell?

Mr. PHILLIPS. Well, if you took away whole life, Mr. Chairman, which is certainly the cornerstone of our business—in the company that I work at, it's about 50–50 between whole life and term.

The CHAIRMAN. You mean you have 50-term now. You have that much term?

Mr. PHILLIPS. Yes. In terms of sales.

The CHAIRMAN. What about in terms of volume?

Mr. PHILLIPS. Yes. Sales volume. We've had that ratio for a long time.

The question is what products would life insurance companies come up with?

The Chairman. I'm intrigued. I didn't realize that you had 50-50 term now even with the savings incentive that's there for whole life.

LIFE INSURANCE IN FORCE IN U.S. LIFE INSURANCE COMPANIES

[000,000 omitted]

Year	Number of Polices*	Amount	Year	Number of Policies*	Amount
1900	14	$8,562	1968	389	$1,266,151
1905	22	13,364	1969	399	1,381,101
1910	30	16,404	1970	402	1,506,472
1915	43	22,777	1971	405	1,620,343
1920	68	42,281	1972	413	1,760,350
1925	101	71,690	1973	417	1,922,311
1930	128	107,948	1974	426	2,144,580
1935	124	100,730	1975	428	2,312,283
1940	137	117,794	1976	429	2,530,767
1945	167	155,723	1977	448	2,788,679
1950	210	242,018	1978	449	3,107,513
1955	266	389,081	1979	458	3,507,495
1960	308	618,189	1980	516	4,055,933
1965	359	958,623	1981	614	4,977,804
1966	372	1,051,701	1982	612	5,459,975
1967	378	1,155,619	1983	615	6,025,540

Note: Totals represent all life insurance in force with U.S. life companies (including both direct business and reinsuance acquired, and without deducting reinsurance ceded, which amounted to $1.170 billion in 1983), whether the policyholders are residents of the United States or of some other country. Figues include credit life insurance.

* Includes group certificates.

Sources: Spectator Year Book and American Council of Life Insurance.

Source: Life Insurance Fact Book 1984.

Mr. Phillips. Approximately.

The Chairman. It's interesting.

Mr. Phillips. I don't think any products would——

The Chairman. You don't see any new ones that you would imaginatively come up with?

Mr. Phillips. Well, there are a lot of new products on the market—universal life, variable life, universal-variable. And I suppose that the minds of the life insurance actuaries and inventive geniuses would be put to work, and it's possible we could come up with something new. I'm not prepared to respond to you as to what that might be.

I would like to, however, if I could, tack on an addition to the answer to your previous question. I would submit that there is an incentive that is working in this country. It's 401(k). And it's working beautifully. The numbers that I have seen suggest that way over three-quarters of those eligible to participate in a 401(k) plan do so.

The Chairman. Senator Heinz.

Senator Heinz. Thank you, Mr. Chairman.

One of the issues that you were discussing with Senator Packwood—and I guess I'm going to aim this at Alan Press and Ted Phillips—is what the effects might be if either the President's or the Ways and Means' proposal was adopted. One aspect we would do well to consider; is how much do we gain versus how big a risk is there? So I guess my first question is: How much revenue would be generated by the President's proposals to tax the inside buildup on whole life? Mr. Press, do you have an answer to that.

Mr. PRESS. Sure. It is our understanding that the potential revenue for 5 years is $200 million if you tax the increase in cash value buildup on an annual basis. That is potential revenue, assuming that the same amount of insurance is sold. However, it is my belief that you will see almost no sale of whole life insurance. Therefore, I don't know where the $200 million of income will come from.

Senator HEINZ. Mr. Phillips or Mr. Deering, do you have any different numbers?

Mr. PHILLIPS. No; I would subscribe to that answer. It's interesting to note that the first 4 years is zero and the 5th year is an estimated $200 million. And I would agree with the answer given by Mr. Press.

Senator HEINZ. Mr. Deering, we really don't know that even the $200 million is an accurate figure. I certainly subscribe to the statement that's been made that this all assumes that whole life insurance will be sold, and in my opinion it will not.

What is the annual volume of the sale of whole life insurance currently?

Mr. PHILLIPS. Nationwide?

Senator HEINZ. Yes.

Mr. PHILLIPS. Well, when you speak of volume in terms of premium volume, our company is 1985 will sell about $80 million of new premium. I would imagine in terms of premium dollars—and this is a guess—it's probably in the range of $4 to $5 billion of new premium annually, whole life insurance.

Do you have a better number on that?

Mr. PRESS. No. I'm afraid not. One number we should have had and we do not have with us.

Senator HEINZ. Over the next 5 years were we not to tax the inside buildup or adopt the staff proposal of Ways and Means? What do you estimate the industry would write for the face value of policies in whole life?

Mr. COX. Well, I don't know if we have that figure, but we do have that the life insurance industry is creating $56 billion of new, additional capital into the market each year. And that has to come from living cash equity of life insurance policies.

Senator HEINZ. I understand that, but that is an apples and oranges comparison because we are talking about something that would apply only prospectively. As I understand the Treasury's proposal, it wouldn't apply to existing policies. But what I am trying to understand concerns the revenue gain of $200 million; with what does that match within the terms of new policy face amounts committed?

Maybe someone could supply that for the record, either Mr. Press or Mr. Deering.

Mr. PRESS. That will be provided.

[The information from Mr. Press follows:]

In 1983 (last year for which figures are available), $971,866,000,000 of ordinary life insurance was sold. Of that, 47% was universal variable or traditional whole life, and 53% was term insurance. (Source: *Life Insurance Fact Book*, 1984, American Council of Life Insurance. pp 12-13.)

Senator HEINZ. One last question. How much revenue would be gained by the Ways and Means staff alternative? That is to treat the loans the way we treat some other distributions.

Mr. PRESS. We have not seen any estimates; nor have we made any on the potential revenue.

Senator HEINZ. Mr. Deering, do you have any estimates on that?

Mr. DEERING. No, I do not.

Senator HEINZ. Mr. Harry Phillips or Mr. Cox?

Mr. DEERING. Excuse me, Mr. Senator, I do have a figure here. A 5-year total of $100 million and the first 3 years zero.

Senator HEINZ. So it would realize about half of what the Treasury estimates; if you believe the Treasury estimates.

Mr. DEERING. I think that this is the amount which is estimated to be in addition to the amount that would have been raised under the administration proposal.

Senator HEINZ. OK.

Mr. DEERING. Now I'm told no. That this is the total amount. This is the total amount of revenue that is estimated by the Ways and Means Committee that would be raised by their proposal.

Senator HEINZ. One last brief question, Mr. Chairman.

Is that a joint tax estimate? Do we know where that estimate comes from?

Mr. DEERING. This estimate comes from the Joint Tax Committee staff.

Senator HEINZ. All right.

Mr. Chairman, thank you. Witnesses, thank you very much.

The CHAIRMAN. Mr. Edward Phillips, one more question. You brought up the 401(k)'s right at the end of your last answer to my question. Now I was giving you the theory that as yet I hadn't seen much evidence that savings incentives actually work, and you said the 401(k)'s. We've only had them since 1981, when the regs went in. Many of the companies have only started putting them in the last year or two. I'm finding much the same thing you are. They are having broad acceptance in companies that have them. What evidence do you have to date that we are getting new savings out of the savings that would not otherwise be savings in some other form?

Mr. PHILLIPS. I wish I had such evidence. I have none. I suspect, however, seriously that if you look at the volume and the increasing level of savings that are represented, savings for retirement by 401(k)'s, that common sense and logic will lead you to the conclusion that some substantial portion of that money would not have been set aside for retirement purposes.

The CHAIRMAN. Or some other savings purpose even, because the pool of savings in this country isn't just retirement. It's all the savings.

Mr. PHILLIPS. Yes, sir.

The CHAIRMAN. And that's the key. When we went with the IRA's, we found that we shifted from one form of savings to another, but we didn't get any net increase in the savings.

Mr. PHILLIPS. Well, I suppose that a net increase could be calculated. And I do not have those numbers. But I strongly suspect and am going on record as being of the opinion that as the results come in, we will conclude there has been a net increase.

The CHAIRMAN. Your intuitive hunch is the same as mine. When I look at how many people are using these, from the president to the janitor in the companies that have them, and how much they are putting aside, it could be a great deal. Or to put it another way, if enough companies continue to add these, it is going to be so much it has got to be more than a shift, I think.

Now next question. I was talking with a company yesterday that has it and I asked—there is a 6-percent employee, 3-percent company—and I asked what is your average contribution. He said about $1,000 to $1,200 for the employees. And I said what difference would it make, then, if the amount were to be brought down, top rate, to $8,000 in terms of the quantity of savings that your employees have. And he said, well, assuming that with that kind of a lower limit we had still decided to go into it, none. The question is with that lower limit would there be a fair number of companies with higher paid executives who would choose not to go into it at all. What's your judgment on it?

Mr. PHILLIPS. Yes, sir, I would agree with that. Particularly those kinds of small corporations in which compensation is not level, in which it varies.

The CHAIRMAN. What about a big company? This fellow kind of smiled and said I'm not sure I would go into it with those limits, but now that we are in it, there is no way we can get out of it with our employees, no matter where you set the limit within reason.

Would a large company with 4,000, 5,000, 6,000 employees go into it knowing that it would benefit 95 percent of the employees if the limits were down at $7,000, $8,000?

Mr. PHILLIPS. I really can't answer that question, Senator. I think to the extent you make any sort of savings incentive plan less attractive to the higher salaried people at the top who typically make the decision, you are going to make the plan less attractive. The exact degree of the impact, I could not predict.

The CHAIRMAN. If anybody has the evidence on the 401(k)'s in terms of the increase in net savings, I would appreciate it because my intuitive hunch is the same as Mr. Phillips. I have nothing to prove it. I just cannot believe these many plans can be going into effect with this quantity of savings and have it just be a shift from savings accounts or a shift from something else and no increase.

I have no other questions. Gentlemen, thank you very much.

Mr. DEERING. Thank you, Mr. Chairman.

Mr. PHILLIPS. Thank you, Senator.

The CHAIRMAN. Now we will conclude with a panel of Robert Beck, Hartzel Lebed, Thomas Anderson, and John Mascotte.

Mr. Beck, why don't you start.

STATEMENT OF ROBERT A. BECK, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PRUDENTIAL INSURANCE CO. OF AMERICA, NEWARK, NJ

Mr. BECK. Thank you very much, Mr. Chairman.

My name is Robert Beck. I'm testifying today in my capacity as chairman and chief executive officer of Prudential Insurance Co. of America. And I do appreciate the opportunity to appear here to express my concerns and my company's concerns about the President's tax revision plan.

Many of us in this room today are upset because we have just spent 4 years examining every aspect of life insurance taxation and setting up a completely new tax system for the industry. And now we are being told the results of that exhaustive effort should be thrown out.

The manner in which we are taxed was completely revised in the Deficit Reduction Act of 1984, as others have testified. The insurance provisions of that legislation were the product of thousands of hours of study, discussion, and negotiation, as the members and staff of this committee well know.

For 4 years, Congress devoted a disproportionate amount of time and effort determining how a taxable income of a life insurance company should be measured, and how much tax revenue the insurance industry should generate. The purpose of that effort was to get rid of outdated legislation that wasn't working and replace it with a simpler, more rational system, a system that would tax life insurance companies on their true economic income.

The 1984 act does just that. It expanded our tax base. It eliminated the special deductions and preferences that do not generally apply to other corporations. It defined life insurance in a way that taxes products that are heavily investment-oriented and imposed a greater tax burden on our industry. We are convinced the 1984 legislation is working and will produce substantially higher revenues, as was intended.

That legislation is sound and should be given a chance—not scuttled before the ink is dry.

I'm especially upset by two of the Treasury Department's proposals. One, the proposal to tax individuals on increases in the cash surrender value of their permanent life insurance. And, two, the proposal to limit the deductions our companies are allowed to take for the reserves we set aside.

The first proposal would subject people who buy permanent life insurance to taxes on income they haven't received and in fact may never receive. If that is ever done, it would discourage people from providing for their own financial security. The Treasury Department has revived this proposal because they want to treat permanent life insurance as an investment or savings account. What their theorists don't understand is that most people buy insurance for protection. My company has a securities brokerage subsidiary, and I can tell you that our stockbrokers don't want to and don't sell life insurance. They don't want to sell it because they don't consider it as an investment, just as most consumers don't consider it as an investment.

Treasury also seems to believe people ought to buy term insurance instead of permanent insurance. But the trouble with term insurance is that it becomes too expensive for most people to keep as they get older. That's why the Veterans' Administration recommends that veterans convert their GI term insurance to permanent insurance if they want lifelong protection. The VA knows firsthand how many World War II veterans kept their insurance as term insurance and became upset and disturbed when they found they couldn't afford to hang onto it.

So here we have two major departments of the Federal Government pushing in opposite directions. Treasury is applying armchair theory; the VA is applying real-life experience. And for all of this, the net revenue gain for Treasury would be negligible because our sales of permanent life insurance wouldn't be anywhere near current or past levels.

The second proposal regarding insurance reserves has to do with the funds we set aside to pay the benefits we guarantee when policyowners die or become disabled. Please don't be confused by the term "reserves." We are not talking here about the sort of funds many other corporations put aside to meet expenses that may or may not be run into down the road. Life insurance reserves are totally different. We are required by State insurance commissioners to set aside funds to make certain we can meet explicit contractual obligations that may span decades. The amounts we set aside are mandated. Those funds represent our liabilities. And they are the single largest expense we have in delivering our product. To deny us deductions for those funds would be the same as denying a manufacturer deductions for the cost of the goods that have been sold.

During the past 4 years, Mr. Chairman, the life insurance industry has had to operate under three different sets of laws. We say, enough is enough. We have been through the mill already. Our taxation provisions have already been reformed. We've already spent an enormous amount of money to comply with changes in our tax laws.

We urge you to reject the Treasury Department's proposals and exclude them from whatever tax reform legislation you may approve.

Thank you, sir.

The CHAIRMAN. Thank you, sir.

[The prepared written statement of Mr. Beck follows:]

STATEMENT OF

ROBERT A. BECK, CHAIRMAN

THE PRUDENTIAL INSURANCE COMPANY OF AMERICA

BEFORE THE SENATE COMMITTEE ON FINANCE

UNITED STATES SENATE

OCTOBER 1, 1985

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I'M ROBERT BECK, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF THE PRUDENTIAL INSURANCE COMPANY OF AMERICA, AND I APPRECIATE THE OPPORTUNITY TO APPEAR HERE TODAY TO EXPRESS MY CONCERNS ABOUT THE PRESIDENT'S TAX REVISION PLAN. MY COMPANY PROVIDES INDIVIDUAL INSURANCE PROTECTION FOR SOME 25 MILLION PEOPLE, AND HAS MORE THAN 60,000 EMPLOYEES, INCLUDING 22,000 INSURANCE AGENTS.

MANY OF US IN THIS ROOM TODAY ARE UPSET BY THE INSURANCE PROVISIONS OF THE ADMINISTRATION TAX PLAN. WE'RE UPSET BECAUSE WE'VE JUST SPENT FOUR YEARS EXAMINING EVERY ASPECT OF LIFE INSURANCE TAXATION AND SETTING UP A COMPLETELY NEW TAX SYSTEM FOR THE INDUSTRY -- AND NOW WE'RE BEING TOLD THE RESULTS OF THAT EXHAUSTIVE EFFORT SHOULD BE THROWN OUT.

THE MANNER IN WHICH WE ARE TAXED WAS COMPLETELY REVISED IN THE DEFICIT REDUCTION ACT OF 1984. THOSE FINAL PROVISIONS HAD BEEN DESCRIBED BY THEN CHAIRMAN DOLE AS A "COMPREHENSIVE REVISION" OF INSURANCE COMPANY TAX LAWS.

LAST YEAR'S LEGISLATION WAS THE PRODUCT OF THOUSANDS OF HOURS OF STUDY, DISCUSSION, AND NEGOTIATION INVOLVING -

-- MEMBERS AND STAFF OF THIS COMMITTEE

-- THE HOUSE WAYS AND MEANS COMMITTEE

-- THE JOINT COMMITTEE ON TAXATION

-- THE TREASURY DEPARTMENT

-- THE GAO

-- REPRESENTATIVES OF THE INSURANCE INDUSTRY

-- AND LEADING EXPERTS FROM OUTSIDE GOVERNMENT AND OUR INDUSTRY

FOR FOUR YEARS CONGRESS DEVOTED A TREMENDOUS AMOUNT OF TIME AND EFFORT DETERMINING HOW THE TAXABLE INCOME OF A LIFE INSURANCE COMPANY SHOULD BE MEASURED AND HOW MUCH TAX REVENUE THE INSURANCE INDUSTRY SHOULD GENERATE.

THE PURPOSE OF THAT ENTIRE EFFORT WAS TO GET RID OF OUTDATED TAX LEGISLATION THAT WASN'T WORKING AND TO REPLACE IT WITH A SIMPLER, MORE RATIONAL SYSTEM THAT WOULD TAX LIFE INSURANCE COMPANIES ON THEIR TRUE ECONOMIC INCOME. IN EFFECT, WE REPRESENTED THE FIRST WAVE OF TAX REFORM.

THE 1984 ACT EXPANDED OUR TAX BASE. IT ELIMINATED THE SPECIAL DEDUCTIONS AND PREFERENCES THAT DO NOT GENERALLY APPLY TO OTHER CORPORATIONS. IT DEFINED LIFE INSURANCE IN A WAY THAT TAXES PRODUCTS THAT ARE HEAVILY INVESTMENT-ORIENTED. IT IMPOSED A GREATER TAX BURDEN ON OUR INDUSTRY BECAUSE IT DOES TAX US ON OUR TRUE ECONOMIC INCOME.

AND LET ME ADD -- BECAUSE WE ARE NOW TAXED ON OUR REAL ECONOMIC INCOME, THE GENERAL PROVISIONS OF THE CURRENT TAX REFORM EFFORT WILL AFFECT US JUST AS THEY AFFECT OTHER CORPORATIONS.

WE'RE CONVINCED THE 1984 LEGISLATION IS WORKING. THE EVIDENCE AVAILABLE INDICATES THE 1984 ACT WILL PRODUCE SUBSTANTIALLY HIGHER REVENUES -- AS INTENDED.

WE BELIEVE THE LEGISLATION IS SOUND AND SHOULD BE GIVEN A CHANCE TO WORK -- NOT SCUTTLED BEFORE THE INK IS DRY. THIS COMMITTEE AND THE REST OF CONGRESS ANTICIPATED THE NEED TO REVIEW THE 1984 ACT AND MANDATED A THREE-YEAR STUDY PERIOD. LET'S WAIT FOR THE FACTS BEFORE WE THROW OUT FOUR YEARS OF WORK.

I'M ESPECIALLY UPSET BY TWO OF THE TREASURY DEPARTMENT'S PROPOSALS -- THE PROPOSAL TO TAX INDIVIDUALS ON INCREASES IN THE CASH SURRENDER VALUE OF THEIR PERMANENT LIFE INSURANCE, AND THE PROPOSAL TO LIMIT THE DEDUCTIONS INSURANCE COMPANIES ARE ALLOWED TO TAKE FOR THE RESERVES WE SET ASIDE TO MEET OUR LONG-TERM OBLIGATIONS TO POLICYOWNERS.

INSIDE BUILDUP

TREASURY WANTS TO SUBJECT PEOPLE WHO BUY PERMANENT LIFE INSURANCE TO TAXES ON INCOME THEY HAVEN'T RECEIVED -- AND, IN FACT, MAY NEVER RECEIVE. IF THAT'S EVER DONE, IT WOULD DISCOURAGE PEOPLE FROM PROVIDING FOR THEIR OWN FINANCIAL SECURITY.

THE TREASURY DEPARTMENT HAS REVIVED THIS PROPOSAL BECAUSE THEY WANT TO TREAT PERMANENT LIFE INSURANCE AS AN INVESTMENT OR SAVINGS ACCOUNT. WHAT THEIR THEORISTS DON'T UNDERSTAND IS THAT MOST PEOPLE BUY INSURANCE FOR PROTECTION. MY COMPANY IS IN THE BROKERAGE BUSINESS AS WELL AS INSURANCE -- AND I CAN TELL YOU THAT STOCKBROKERS DON'T WANT TO SELL LIFE INSURANCE. THEY DON'T WANT TO SELL IT BECAUSE THEY DON'T CONSIDER IT AN INVESTMENT.

THE AVERAGE PERMANENT LIFE POLICY HAS A DEATH BENEFIT OF ONLY $18,000. TWO-THIRDS OF ALL PERMANENT LIFE POLICIES COVER PEOPLE EARNING LESS THAN $25,000 A YEAR. THAT CERTAINLY IS NO HIGH-POWERED INVESTMENT.

TREASURY'S THEORISTS ALSO SEEM TO BELIEVE PEOPLE OUGHT TO BUY TERM INSURANCE INSTEAD OF PERMANENT INSURANCE. BUT THE TROUBLE WITH TERM INSURANCE IS THAT IT BECOMES TOO EXPENSIVE FOR MOST PEOPLE TO KEEP AS THEY GET OLDER. THAT'S WHY THE VETERANS ADMINISTRATION RECOMMENDS THAT VETERANS CONVERT THEIR GI TERM INSURANCE TO PERMANENT INSURANCE IF THEY WANT LIFELONG PROTECTION. THE VA KNOWS FIRSTHAND HOW MANY WORLD WAR II VETERANS KEPT THEIR TERM COVERAGES AND BECAME UPSET WHEN THEY FOUND THEY COULDN'T AFFORD TO HANG ONTO THEM.

SO HERE WE HAVE TWO MAJOR DEPARTMENTS OF THE FEDERAL GOVERNMENT PUSHING IN OPPOSITE DIRECTIONS. THE DIFFERENCE IS BETWEEN ARMCHAIR THEORY AND REAL-LIFE EXPERIENCE IN ADMINISTERING MASSIVE INSURANCE PROGRAMS.

IF YOU FOLLOW THE SOUND ADVICE OF THE VA AND BUY PERMANENT INSURANCE, YOU WOULD GET TAXED UNDER THE TREASURY PROPOSAL. IN FACT, THE OLDER YOU GET THE GREATER THE TAX -- ALL ON AMOUNTS YOU HAVEN'T RECEIVED. BUT IF YOU FOLLOW THE TREASURY'S LINE AND BUY TERM INSURANCE, YOU WOULDN'T BE ABLE TO AFFORD TO KEEP IT AS YOU GET OLDER. SO THE TREASURY PROPOSAL WOULD REALLY PUT PEOPLE IN A NO-WIN POSITION.

AND THE NET REVENUE GAIN FOR TREASURY FROM A TAX ON PERMANENT LIFE INSURANCE WOULD BE NEGLIGIBLE. IT WOULD BE A PITTANCE BECAUSE OUR SALES OF PERMANENT LIFE INSURANCE WOULDN'T BE ANYWHERE NEAR CURRENT OR PAST LEVELS.

WE ESTIMATE THAT WITHIN THREE YEARS A TAX OF THAT SORT WOULD REDUCE PRUDENTIAL'S PREMIUMS ON SALES OF PERMANENT LIFE POLICIES FROM $440 MILLION A YEAR TO ABOUT $18 MILLION. ONLY 5,000 OR 6,000 OF OUR 22,000 AGENTS WOULD BE ABLE TO SURVIVE. OUR SUPPORT STAFF OF 14,000 WOULD PROBABLY HAVE TO BE CUT ALMOST IN HALF.

THOSE ARE OUR BEST ESTIMATES FOR THE PRUDENTIAL. THE TREASURY'S PROPOSAL WOULD PROBABLY COST MORE THAN A QUARTER MILLION JOBS IN THE INSURANCE INDUSTRY AS A WHOLE.

RESERVES

THE TREASURY PROPOSAL REGARDING INSURANCE RESERVES HAS TO DO WITH THE FUNDS WE SET ASIDE TO PAY THE BENEFITS WE GUARANTEE WHEN POLICYOWNERS DIE OR BECOME DISABLED. DON'T BE CONFUSED BY THE WORD "RESERVES." WE'RE NOT TALKING HERE ABOUT THE SORT OF FUNDS MOST CORPORATIONS PUT ASIDE TO MEET EXPENSES THEY MAY RUN INTO DOWN THE PIKE. MOST CORPORATIONS HOLD THOSE TYPES OF FUNDS AT THEIR OWN DISCRETION -- AND THE EXPENSES THEY ANTICIPATE MAY NEVER MATERIALIZE.

BUT LIFE INSURANCE RESERVES ARE TOTALLY DIFFERENT. WE'RE REQUIRED BY STATE INSURANCE COMMISSIONERS TO SET ASIDE FUNDS TO MAKE CERTAIN WE CAN MEET EXPLICIT CONTRACTUAL OBLIGATIONS THAT MAY SPAN SEVERAL DECADES. THE AMOUNTS WE SET ASIDE ARE MANDATED AND BASED ON ACTUARIAL STANDARDS. THOSE FUNDS REPRESENT OUR LIABILITIES, AND THEY ARE THE SINGLE LARGEST EXPENSE WE HAVE IN DELIVERING OUR PRODUCT. TO DENY US DEDUCTIONS FOR THOSE FUNDS WOULD BE THE SAME AS DENYING A MANUFACTURER DEDUCTIONS FOR HIS COST OF GOODS SOLD.

FOR MORE THAN 70 YEARS OUR FEDERAL TAX LAWS HAVE RECOGNIZED THE PURPOSE SERVED BY OUR RESERVE DEDUCTIONS IN MATCHING INCOME AND RELATED EXPENSES WITHIN THE SAME TAX PERIOD. UNDER THE TREASURY PROPOSAL, SMALL AND GROWING COMPANIES WOULD BE CAUGHT IN THE SQUEEZE BETWEEN RESERVE REQUIREMENTS AT THE STATE LEVEL AND THE DENIAL OF RESERVE DEDUCTIONS AT THE FEDERAL LEVEL -- WHICH, IN EFFECT, REQUIRES THE PREPAYMENT OF TAXES.

THE TAX TREATMENT OF INSURANCE RESERVES IS A DIFFICULT TECHNICAL ISSUE. BUT I CAN ASSURE YOU THERE IS ABSOLUTELY NOTHING NEW ABOUT THE TREASURY PROPOSAL. THIS VERY SAME PROPOSAL WAS THOROUGHLY CONSIDERED -- AND REJECTED ON ITS MERITS -- WHEN THE 1984 ACT WAS DEVELOPED.

I BELIEVE THE TREASURY DEPARTMENT HAS RESURRECTED THESE TWO PROPOSALS BECAUSE THEIR THEORISTS ARE BOUND AND DETERMINED TO FIT LIFE INSURANCE INTO THE SAME MOLD AS FINANCIAL SERVICES THAT SERVE ALTOGETHER DIFFERENT PURPOSES. TO DO THAT THEY IGNORE THE UNIQUE CHARACTERISTICS OF INSURANCE -- AND THEY TOTALLY DISREGARD CONGRESS' EXHAUSTIVE FOUR-YEAR STUDY OF LIFE INSURANCE TAXES AND YOUR THOROUGH REVISION OF THOSE TAX PROVISIONS.

CONCLUSION

DURING THE PAST FOUR YEARS THE LIFE INSURANCE INDUSTRY HAS HAD TO OPERATE UNDER THREE DIFFERENT SETS OF LAWS -- THE 1959 ACT, THE 1982 STOPGAP LEGISLATION, AND THE 1984 ACT. WE SAY, "ENOUGH!"

WE'VE BEEN THROUGH THE MILL ALREADY. OUR TAXATION PROVISIONS HAVE ALREADY BEEN REFORMED. WE'VE ALREADY SPENT AN ENORMOUS AMOUNT OF MONEY TO COMPLY WITH CHANGES IN OUR TAX LAWS.

I URGE YOU TO REJECT THE TREASURY DEPARTMENT'S PROPOSALS AND EXCLUDE THEM FROM WHATEVER TAX REFORM LEGISLATION YOU MAY APPROVE.

STATEMENT OF HARTZEL LEBED, PRESIDENT, CIGNA CORP., PHILADELPHIA, PA

The CHAIRMAN. Mr. Lebed.

Mr. LEBED. Thank you, Mr. Chairman. I'm Hartzel Lebed. I'm president of CIGNA Corp., a major provider of all forms of insurance, employee benefits, and asset management services.

CIGNA fully supports the testimony given earlier today by the American Council of Life Insurance and the American Insurance Association. We are members of both organizations.

Mr. Chairman, like many other Americans, we believe the most important issue facing Congress is deficit reduction. But we very much appreciate the opportunity to express views on the administration's tax proposals, and I think I can do that in about 5 minutes.

To get right to the point, CIGNA believes that a number of the administration's recommendations would impose inappropriate, new taxes on our customers, our many thousands of employees and agents, and on our companies. There are literally dozens of issues that concern us.

I will limit my comments to two broad areas. First, the taxation of life insurance companies, and, second, congressional policy with respect to the taxation of consumers of insurance and related products.

First, regarding life insurance company taxes, certain of the administration's proposals would reopen issues acted upon by this committee, the Congress and the administration only last year. Fairness and practicality would seem to dictate that these issues should not be readdressed, certainly not until considerably more experience has been gained with the 1984 legislation. The 1984 life company tax rules were carefully crafted to accomplish five things. First, to recognize the very long-term nature of the life insurance business. Second, to impose a reasonable tax burden on the industry. Third, to apportion that tax fairly between segments of the industry. Fourth, to avoid undue damage to small life insurance companies. And, fifth, to adjust the industry tax to a fair level relative to other industries.

These considerations resulted in several special life company taxation rules, which is quite natural given the unique long-term nature of the life insurance business. These rules and the delicate balance they have successfully created should not be disturbed without much more experience.

And that brings me to my second point. If company taxes are further increased, this will inevitably result in increased costs to our consumers. In addition, other administration proposals would directly modify the tax treatment of our products; thereby, further increasing the cost to consumers of many essential types of coverage.

Mr. Chairman, in my opinion, an appropriate and important way to view what has evolved in our country over many decades is, in effect, two systems of Social Security. One is the publicly financed and administered system, the combination of the two programs generally referred to as Social Security and Medicare. This public system deals primarily with the country's senior citizens. The other is the privately financed and administered system that deals primarily with our workers and their families. This consists of thousands of private sector companies providing products and services to millions of individuals, and thousands of employers, unions, and professional associations sponsoring for their employees and members various programs of protection against the many hazards that can disrupt an individual's or family's economic security.

Both systems are essential to the economic well-being of virtually all Americans. Now here is what I'm getting at. Social policy developed by you and your predecessors over many decades provides tax incentives for individuals and businesses to protect themselves and employees against financial distress caused by death, disability, old age, loss of property and so forth. Accordingly, through operation of the tax laws, Congress is an active partner in what I have called the "private Social Security system."

This system should not be reversed or put at risk in favor of a theoretical concept of tax neutrality. The Congress should recognize that insurers and many other private organizations capitalize and administer this system. In its absence, the public would demand the Government devise funds and administer replacement programs.

Through this system life insurance, retirement income, disability income, medical insurance, automobile and homeowners' insurance is provided to over 160 million Americans. Not all services are used by all Americans. Not all possible benefits are provided by all employers. Identical treatment for all simply is not possible. But for all its imperfections, the present systems works very, very well. They encourage self reliance. Congress should continue to encourage self reliance.

The proposed changes to present tax laws taken in the aggregate would have a profound effect on the private system of Social Security and inevitably would diminish the success of the private sector in providing needed services and the ability of the American people to afford them.

Senator **BENTSEN**. Thank you very much.

[The prepared written statement of Mr. Lebed follows:]

PREPARED STATEMENT OF HARTZEL Z. LEBED

Mr. Chairman and Members of the Committee: My name is Hartzel Z. Lebed. I am President of the CIGNA Corporation, a major multi-line insurance carrier employing 47,000 people. We provide life, health, welfare and retirement benefit plans to individuals and employers of all sizes, throughout the United States. Also, we are a major property and casualty insurer with both domestic and international operations. We write both personal lines and commercial liability coverage. I want to thank the Committee for allowing me to testify today.

CIGNA is an active member of both the American Council of Life Insurance and the American Insurance Association, both of whom are testifying today before this Committee. We have worked closely with each of them on the development of their testimony and fully support the views they express.

Mr. Chairman, we support careful Congressional assessment of the federal income tax to insure that individuals and corporations pay their fair share of taxes. We understand that many Senators and Representatives wish to address both tax reform and deficit reduction, but are uncertain which to address first. In CIGNA's view, deficit reduction ought to be the government's number one ecomonic priority, with tax reform an important, but secondary focus.

The President, nevertheless, has sent to Congress his proposals for tax reform. We believe it is unfortunate that a number of these proposals would impose inappropriate new taxes on insurance companies and their products. Generally, the proposals fail to consider that the Internal Revenue Code is, and ought to be, must more than an expression of tax policy. The Code reflects and implements important social policy decisions made by Congress.

Further, certain of the Administration's proposals would re-open issues acted upon only last year by this Committee. Fairness dictates that these issues should not be readdressed, certainly not until some experience has been gained with the existing structure. Other, newer proposals would modify the taxation of insurance companies and their products. This would increase the cost to consumers of many essential types of insurance coverage which, in the aggregate, provide much of the nation's privately funded support systems. These systems enable the private sector to furnish economic protection against current and future hardships.

CIGNA believes the present private sector system is working quite well. In the absence of a showing that abuses exist, the present system should not be cast aside in favor of a theoretical goal of an absolutely investment-neutral tax code. CIGNA believes the tax policy shaped by this Committee should continue to consider social as well as economic goals.

Proposals that would impact our companies and products fall into two groups: the ones that Congress considered and acted upon last year, and new proposals advanced by the Treasury and others during the present tax reform debate.

During the 98th Congress, this Committee, and the Ways and Means Committee in the House of Representatives, gave careful consideration to taxation of life insurance companies and to the tax treatment of inside buildup on permanent life insurance and annuities. That consideration was the culmination of five years of review, a process that began in 1979 with a request for a study by the General Accounting Office. That study made recommendations for changes, many of which were adopted by the Congress.

The process was not a simply one. In 1982 Congress enacted "stop-gap" legislation which carried the industry through the next two years. This was a temporary solution to genuinely difficult technical and policy issues. The result, however, was a period of great uncertainty for the life insurance industry. The industry was unable to know what the law would be, how the revisions would impact its products, or whether it could market existing or planned products. Ultimately in 1984, Congress passed a new life insurance tax law as part of the Deficit Reduction Act of 1984.

As part of that legislation, the Congress firmly rejected a tax on the inside buildup on life insurance policies. Similar considerations applied to annuities. The life company tax rules were carefully crafted to impose a reasonable tax burden on the industry, a reasonable split between segments of the industry, to provide appropriate protection for small, young, growing insurance carriers, and to adjust the tax to a fair level relative to other industries.

The ink on this legislation is not yet dry. We believe it inappropriate for the Treasury now to propose yet a new modification to the tax laws that were considered only last year. This is especially so becaue many of Treasury's proposals are precisely the ones Congress declined to accept last year. I must stress that Treasury was a party to the legislative product of 1984, and, indeed, gave its endorsement before this Committee. Now let me turn my attention to some specifics:

1. PROPOSED TAX ON "INSIDE BUILDUP" IN PERMANENT LIFE INSURANCE AND ANNUITIES

Under the Administration's proposal, life insurance and annuity policyholders would be taxed each year on the so-called "inside buildup" in the policy to the extent it exceeds the taxpayer's basis in the contract.

The proposal to tax inside buildup was an early proposal in the legislative process that ultimately resulted in the revised insurance tax rules enacted in 1984. Congress rejected this proposal for many good reasons. Those reasons are just as valid in 1985 as they were in 1984:

The owner of a permanent life insurance policy would not be treated as if he has realized a gain merely because earnings have been credited to the policy. This would be the same as suggesting that homeowners be taxed on the increase in value of their homes before the home is sold. To do so would be a remarkable change in Congressional policy.

Permanent life insurance is a security vehicle, not an investment instrument. Americans buy life insurance to provide for their families in the event of their death. The level-premium nature of permanent life policies enables policyholders to spread the total cost of their life insurance evenly over the life of the policy. Policyholders choose this type of policy in order to avoid the sharp increase in term-life premiums that corresponds with advancing age.

The proposed tax will confuse and anger millions of Americans. Why should a policyholder pay a tax to the federal government for the privilege of purchasing protection and security in the form of permanent life insurance?

The present tax treatment of inside buildup is consistent with the sound policy judgment that individual Americans—not the Federal government—should be encouraged to be responsible for the financial security of their families.

In enacting DEFRA, Congress, with Administration concurrence, narrowed the definition of life insurance, restricting the investment orientation of some policies being sold at the time.

Permanent life insurance is purchased predominantly by moderate- or middle-income individuals. Three quarters of those insured under permanent life policies are heads of households having a total family income of less than $25,000. They buy the policies for protection—not as a tax shelter.

Similarly, the Administration has proposed to tax the inside buildup in a deferred annuity contract to the extent that it exceeds the owner's basis in the contract. We urge this Committee to reject this proposal.

Like taxation of inside buildup on life policies, the issue was considered in 1984, as it had been in 1982.

Specific limitations were added that assure that deferred annuities are used for long-term retirement protection and not as short-term investment vehicles.

All earnings in a deferred annuity eventually will be taxed.

The annuitant benefits principally from the financial security that comes from the guaranteed stream of retirement income. This is wholly consistent with longstanding national retirement policy. Congress should not place barriers before Americans who seek ways of protecting themselves from hardship in later life.

The Administration has proposed three changes that would increase life insurance company taxes: It would establish a new method of computing company reserve deductions; it would eliminate the special deduction for life insurance companies (the "TIA"); and it would repeal the provisions for small companies.

Again, Treasury has walked away from the compromise legislation enacted last year. Each of these company tax provisions was an integral part of that compromise. We cannot accept the Treasury's proposals, and, indeed, we are more than a little surprised at their introduction.

Under current law, life insurance companies are allowed a deduction from taxable income for any net increase in life insurance reserves. DEFRA significantly reduced this deduction. It limits the life insurance reserve deduction for any contract to the greater of the net cash value of the contract or the reserve for policy claims generally equal to the minimum reserve required to be held under state law.

The Administration proposes, in computing the reserve deduction, that the life insurance reserve for any contract be limited to the net cash surrender value of the contract. A special rule would be provided for current annuity contracts that may not be surrendered for cash. The effect of the proposal would be to reduce early year reserve deductions for ordinary life insurance contracts to an amount less than required to be held under state law. It would deny any reserve deductions for most policies of term and group insurance and for many supplemental benefits which do not have any cash value.

The Administration asserts that the current levels of tax reserves are too high, but this is not so. The new rules enacted in 1984 are far more stringent than the prior ones. Tax reserves must conform to the statutory requirements of at least 26 states or to the cash surrender values of each contract, if greater.

Under the administration's proposal, for contracts without cash values, a deduction will be allowed only for the claim payments when made. For contracts with cash values, deductions will be available only for the net surrender value when available to the policyholder in cash. This totally ignores the obligation of a company in the life insurance business to set aside reserves each year for its obligations to pay insurance claims as they arise in the future.

A life insurance company has an obligation to pay a specified amount to a policyholder on the occurrence of a specified event such as death, survival or disability. The cost of the services provided by a life insurance company for which it must receive a tax deduction when the related income is received is the value of this insurance obligation (net of premiums to be received in the future). The company has this obligation whether or not a particular policy contains a net surrender value. If a reserve deduction is not allowed for this insurance obligation, the resulting tax is equivalent to a tax not on income but on premium deposits. In this situation a company is essentially required to make an interest free loan to the government equal to the tax on its entire reserve obligation.

Furthermore, the provision of DEFRA dealing with increases in reserves is part of the total life insurance company tax provisions that were carefully crafted to maintain balance in tax revenues paid and in product costs among all segments of the life insurance industry. A change in one of these provisions could lead to a collapse of the compromise so recently achieved.

As a result of the 1984 legislation, a life insurance company is allowed a special deduction in an amount equal to 20% of its adjsuted taxable income. This deduction applies only with respect to income resulting from a company's insurance business.

The Administration's proposal would repeal the life insurance company special deduction. Again, Treasury seeks to walk away from the compromise struck last year.

There are substantial reasons to retain the special life company deduction:

The special deduction is an integral part of the overall tax scheme that replaced the 1959 Act. It cannot be abandoned without collapsing the rest of the 1984 company tax structure.

The 1984 law changes broadened the industry tax base. Without the special deduction the level playing field vis-a-vis other financial institutions would be destroyed.

The special deduction replaced many complex deductions allowed under prior law. These deductions reflected the long-term nature of the life insurance business and the difficulty of measuring economic income on an annual bassis.

Under present law, a small life insurance company is allowed a deduction equal to 60% of the first $3 million of its adjusted taxable income. This deduction phases out as that income increases from $3 million to $15 million. The small company deduction is allowed only to companies with gross assets of less than $500 million.

As with the other components of the 1984 compromise, there is a sound basis for continuing the small life insurance company deductions.

The small company deduction replaced a part of the complex rules under the 1959 Act.

The small company deduction permits small companies to grow within the life insurance industry. Congress has frequently given favorable tax treatment to small business and to new, entrepreneurial ventures.

The small company deduction is an important element in the overall "segment balance" that made the 1984 comprimise possible.

In summary, permanent insurance, annuities, and life insurance companies have been the subject of recent Congressional scrutiny and, indeed, the subject of substantial tax reform. The legislative product of that massive effort ought not to be abandoned. Revisiting those issues now as Treasury suggests is not only unnecessary, it would be a breach of faith.

The original decision of Congress to grant a tax favored status to employee benefits was based on sound social policy which is no less meaningful today. Tax policy has fostered employee benefits economically and efficiently in the workplace so that the majority of Americans have health and income protection. Unfortunately, tax expenditures associated with employee benefits have been overstated and ignore the social value of these benefits as a valid goal of tax policy.

We at CIGNA are concerned that provisions occasioned by tax reform that affect employee benefits could significantly damage a benefit delivery system that is generally operating well and is benefitting millions of American workers and their families. We are particularly concerned that tax reform proposals would have the unintended effect of drastically reducing socially desirable and necessary benefits for the low- and middle-paid. Within this general framework, I will discuss specific benefit proposals—helth cap/floor, uniform non-discrimination coverage rules for pension and welfare benefit plans, and 401(k) retirement savings plans.

The present tax treatment of employer-provided group health insurance has contributed significantly to a sound health care system for American workers. Universal private health coverage for all employees and their dependents is a worthy national social goal. Cutting back on these tax incentives would postpone, possibly permanently, the realization of universal coverage. Thus, taxing employer-provided health insurance is inappropriate whether the tax is in the form of a floor or a cap.

Health insurance is the most widespread employee benefit. Sixty percent of all civilian workers have primary health insurance coverage and another 20 percent have secondary coverage. Eighty percent or more of covered workers earn less than $25,000. The addition of dependents to the 63 million workers covered results in over 162 million Americans under age 65 being covered by group health insurance.

The original Treasury proposal would have limited the amount an employer could contribute to an employee health care benefit plan without a tax to the employee. That cap was $70 per month for an individual and $175 per month for a family.

The burden of a tax cap would fall unequally on workers depending upon where they work, their ages and their occupations, Taxing group health insurance this way would discriminate against workers in high health care cost areas. A tax cap would also have its heaviest impact on groups composed primarily of older workers whose health care costs are more than those for the younger workers. A cap would discriminate against workers employed in high-risk or hazardous occupations since higher health premiums must be paid to cover the risks.

A cap would place essential preventive health care in jeopardy since employers would be discouraged by the cap from making contributions for other than catastrophic coverage.

Finally, a cap would involve difficult and costly problems of administration and reporting.

The Administration now proposes a monthly "floor" of $10 for indiviuduals and $25 for families instead of a cap. Approximately 63 million workers would have new income to declare if initial health insurance premium dollars are taxed.

The floor at $10 and $25 is unlikely to cause a drop in benefits provided; however, that would clearly not be the case if the floor "rises." EBRI research indicates that as more and more of the health benefit is taxable, more and more workers will not want it, preferring cash compensation instead. Adverse selection will be most intense among younger workers. As a result, the cost of insurance for all others will increase. Over time, this could have dire consequences especially when the Congress is already concerned about those without health insurance.

The floor concept avoids some of the worst inequities and problems posed by the cap, *i.e.*, the burdens imposed on the elderly, the handicapped, high risk employees, and workers in areas of high health costs. But there are other serious flaws with the floor. Because the bulk of health benefits go to lower - and middle-income workers, any tax on these benefits will hit hardest on lower- and middle-income families.

This problem is accentuated under the floor concept. The floor would not only mean increased income taxes but increased Social Security taxes for most lower-and middle-income workers. While many of these workers would have increased taxable income and Social Security taxes under the cap, most would be faced with this problem under the floor. Under the President's proposal, however, there would be the offset of lower income tax rates.

Finally, under the floor concept people who receive different health care benefits would be liable for the same tax. Those whose coverage was limited to a contributory hospital benefit plan could pay the same tax as those in the same tax bracket in a non-contributory comprehensive health plan.

Regardless of how tax on health benefits is structured, it will introduce a disincentive for employees to continue their health insurance coverage. This should be the overriding concern since the dismantling of plans that will follow will move the burden of providing health care to the government. Thus, we are opposed to taxation of employer contributions to health benefit plans. We strongly urge you to reject these proposals.

An appropriate goal of employee benefits tax policy is, and should continue to be, the broad distribution of benefits throughout the workforce on a non-discriminatory basis. This goal is being achieved, EBRI research indicates that the distribution of present coverage under tax favored employee benefit programs almost exactly matches the wage and salary structure of the workforce. We support reasonable and workable endeavors to seek broader coverage; however, the proposed uniform non-discrimination rules will not promote that goal.

The President's proposal introduced "uniform" non-discrimination rules with respect to employee coverage for pension plans and all welfare benefit plans. Although captioned as a uniform rule, they are in reality separate rules for pension and welfare benefit plans. These proposed rules will seriously impact existing plans that are operating free from discrimination under current law. In fact, large numbers of sponsors of established plans have found that their plans could not qualify under the proposed scheme.

Current law requires that all qualified employer-sponsored retirement plans meet specific non-discriminatory coverage requirements. Failure to meet the coverage test triggers disqualification of the entire plan. A plan must meet either one of two numerical percentage tests or a subjective test known as "the non-discriminatory classification" test. This test permits needed employer flexibility in installing qualified plans that realistically reflect the needs of the work environment.

The proposed test would require aggregation of all corporate operating entities within a controlled group and then compliance with a mechanical and arbitrary percentage test. The new test deprives any business with a variety of operations the flexibility necessary to fashion benefit programs to best meet the needs of a diverse employee group.

Pension plans are part of an employer's compensation package. Just as an employer pays the prevailing wage rate in a locale, so does it also offer benefit packages that are the most desirable to attract employees in that region and particular line of business. Pensions and other employee benefits reflect the wage market. So, if an employer is competing for wage earners in a particular locale, it must give the mix of benefits wage earners in that locale need, be it a particular type of retirement benefit, health and disability benefits, or life benefit.

It is unlikely that coverage will be increased under the Proposal's new coverage rules. It is more likely that if the qualified plan is continued and benefits must be uniform across all divisions of a business, benefits will be made uniform at relatively low levels.

It would be difficult to overemphasize the harm imposed by this mechanical test. The policy decision which this proposal represents will have far reaching effects on the strength of the private retirement system and retirement security of American workers for years to come.

Under current law, an employee may exclude from income certain employer-provided welfare benefits. Except for insured medical benefits and disability income, each welfare benefits has its own non-discrimination rule.

The uniform coverage test for welfare benefits would require that all welfare benefit plans meet a coverage test based on utilization as well as meeting three additional tests on benefit availability, non-discriminatory benefits, and concentration. In addition, the rules would require that each type and level of benefit be tested as a separate plan. A plan's failure to satisfy any one of the anti-discrimination tests would result in the prohibited group being taxed on such benefits.

Such requirements unduly restrict the employer's ability to offer flexibility in benefits which enables an employer to match benefits to employee needs. For cost containment and other reasons many employers have established various levels of welfare benefits, *e.g.*, medical benefits, which may be elected by an employee. Employee needs may vary for many reasons, including geographical location or coverage under a spouse's plan. Testing each option on the basis of actual participation continually raises the prospect of a program's disqualification as participation in the plan can vary from year to year.

The rules create especially difficult problems for small employers. The concentration test requires that employer contributions for benefits on behalf of the highest paid twenty employees in the prohibited group cannot exceed 25% of the company's total contributions for that benefit. This concentration requirement will make provision of group life and health coverage by small employers virtually impossible to maintain.

It is especially troublesome to base the discrimination tests on all employees of a controlled group. In today's environment, corporations frequently operate several businesses with different practices, profit margins and compensation packages determined by prevailing market conditions in each of the individual industries. To require essentially equal welfare benefits for disparate groups of employees merely because they are employed by employers related for tax purposes, is as unreasonable as requiring identical wage packages. Different companies within an affiliated group of companies should be allowed to design their own balanced benefit program, taking into consideration the needs and desires of their own employees and benefits given by competitors in that industry and in that geographical area.

These tests imposed on flexible benefit plans are even more difficult to meet. The complete inability of plan sponsors to predict whether flexible benefit coverages will satisfy the proposed non-discrimination requirements will probably eliminate or curtail most existing programs and preclude the establishment of any new such programs. Thus, cafeteria plans that have been so successful in allowing employees to choose the benefit package that makes the most sense at a particular age and salary level could disappear.

The proposed uniform non-discrimination rules pose serious problems for plan sponsors and employees. They substantially add to administrative complexity and would reverse the current pattern of designing employee benefits to meet individual needs. We believe these proposed rules would have a negative effect on what has been an extremely beneficial system for the American worker. We believe the proposed rules would not meet the Administration's objective of broader coverage.

Small employers are likely to respond by dropping coverage and large employers are likely to offer less comprehensive and less flexible coverage.

More importantly, current law rules for maintaining non-discriminatory coverage and broad distribution throughout the workforce are working.

An ACLI study shown that coverage and benefit receipt under private pension plans is widespread and will increase significantly in the future as the system matures. Additionally, EBRI's research findings indicate that benefits are widely distributed across all income levels throughout the workforce. In 1983, 76% percent of all workers covered by an employer pension plan under ERISA standards, and 78% percent of all workers covered by an employer group health plan with their employer, earned less than $25,000.

To be sure, the current system of employer-provided benefits can be improved. But we believe that the privately provided employee benefits system is generally working well, and as Congress intended. Where gaps in coverage or specific problems are identified, we believe the better approach is to target specific solutions to those specific problems.

Cash or deferred arrangements, also referred to as Section 401(k) plans, have become an increasingly popular retirement savings plan. Since 1981, when the Internal Revenue Service published preliminary regulations governing 401(k) these plans have spread rapidly. 401(k) plans are sponsored by a large and growing number of employers and participation in them is not limited to the highly compensated. The Employers Council On Flexible Compensation (ECFC) 1985 survey suggests that 401(k) plans may now cover 28% of the private sector work force. According to the EBRI/HHS May, 1983 Current Population Survey Pension Supplement, of 2.7 million surveyed employees covered by 401(k) plans, 54.6% of them earned less than $25,000.

The ability to save on a pre-tax basis, accessibility to funds through loan or withdrawal provisions when special needs arise and employer matching contributions make these plans attractive to young and lower paid employees. Without these incentives given 401(k) plans by the tax law, it is doubtful employers would establish or continue to maintain these plans or that employees would sufficiently utilize them.

Arguing that section 401(k) plans act to circumvent the contribution limitations on IRAs, the Treasury Department tax reform proposal recommended that section 401(k) plans be repealed. The May 1985 Reagan proposal proposed instead that the plans be capped below levels available in other qualified retirement plans, that IRA contributions be offset against the contribution limit on section 401(k) plans, and that stricter non-discrimination requirements be made applicable to these plans than to other qualified plans. In addition, 10 year forward income averaging would no longer be available for lump-sum distributions from any qualified retirement plan and pre-retirement plan distributions would be subject to an excise tax.

We believe this proposal creates a number of disincentives to participation in these plans by all employees, but particularly by low and middle income employees.

Section 401(k) plans are the contributory retirement plan vehicles that are most broadly used. Restrictions on contributions to and withdrawals from section 401(k) plans would reduce their attractiveness as retirement/savings programs.

There has been a long-standing national commitment to providing incentives for private pensions and capital accumulation plans. They are critical components in the three legged stool of retirement income security—Social Security, private pensions and individual savings. While increasing savings is not a necessary part of tax reform, the Administration's tax reform proposal contains initiatives aimed at increasing savings. Restrictions on loans and hardship distributions would work against these initiatives by reducing savings incentives.

The new proposed average deferral percentage test (ADP test), would allow a much more narrow differential between the prohibited group and the rest of the employees. The test would also require that the deferral percentage of each individual in the prohibited group be measured against the average deferral for other participants.

The combined effect of these elements of the proposed new test is that the elective deferral allowed each member of the prohibited group would be much smaller than under the present deferral test; and, this is without regard to the $8,000 limitation. This greatly diminishes the relative value for many employees.

The rules would also greatly complicate administering a 401(k) Plan. In combination, these factors will cause many employers to feel that it is not worth the added expense of maintaining the plan.

We believe that the 401(k) should remain as it is under current law. It is a highly effective retirement/savings program for employees. It offers especially good coverage for young and lower income employees.

As an employer-sponsored plan, it is a more effective savings-retirement mechanism than an IRA—offering more employee protection because it is under ERISA. Furthermore, a 401(k) encourages savings on a disciplined basis through pay-roll deduction. Additionally, studies show that the IRA's are utilized mainly but higher income and older individuals; thus, where employer-sponsored 401(k) plans exist, broader coverage is achieved.

Section 401(k) plans can help meet the need for retirement income security among mobile workers and workers with intermittent labor-force participation. Employee elective contributions to 401(k) plans are, by law, fully and immediately vested. Furthermore, if an employer provides a matching contribution, the vesting period for it is generally shorter than under other employer-sponsored plans.

Thus, 401(k) plans fill an extremely valuable social need and national economic purpose by encouraging retirement savings and capital accumulation for lower- and middle-paid as well as high paid employees. We need greater encouragement for retirement savings not less. The tremendous administrative complexities and severe restrictions from current law in the original President's proposal will work against retirement savings by jeopardizing 401(k) plans and creating disincentives for continued employee participation and employer maintenance of such plans. The enormous retirement and savings benefit of Section 401(k) plans could be virtually lost.

Under current law, an insurance company includes premiums received on property and casualty policies (including accident and health insurance) in taxable income as they are earned over the terms of the policies. Policy losses are deducted when incurred through a mechanism of reserving for incurred but unpaid losses whether or not the losses have been reported during the year.

Several proposals have been advanced which would reduce the deductions allowed to insurance companies for their incurred losses on these coverages. The Administration has proposed a "Qualified Reserve Account" (or "QRA") approach, which would permit a deduction for only part of an insurer's unpaid losses (i.e., claims not yet paid). The General Accounting Office ("GAO"), on the other hand, has proposed to allow the full amount of such losses to be deducted, but to spread the deduction over a period of time. In simple contrast, current law follows State regulatory accounting by recognizing the full amount of the losses as liabilities, and deductions, in the year they are established. Neither the QRA nor GAO proposal should be adopted.

The QRA proposal would impose what is effectively cash method accounting on the unpaid losses of accrual basis insurers. It would do this by requiring any amount deducted as an unpaid loss to be accumulated with interest (at the insurer's after-tax rate of return on its portfolio investments) and then to be brought back into income at the time the related claims are paid. The same economic result is produced by flatly denying the unpaid loss deduction and granting a deduction only when the claims are paid.

Cash method accounting would mismeasure the economic income of insurers. It would fail to recognize that expenses (claims) paid in later years arise from, and should be matched with, premium income received in an earlier year.

QRA accounting may encourage businesses to go without insurance coverage (the typical status of the so-called "self-insured" party) rather than purchase insurance. This follows from the fact that, in present value terms, it is cheaper to "fund" for a loss by means of capital retained in a business (which earns a higher, equity-type return) than to pay an insurer the greater amount it would need (based on a lower, portfolio-type return) to cover the loss.

Insurance is naturally more efficient (and more realistic) than "self-insurance," and the tax system should not discourage its purchase by making it relatively more costly to insure.

The QRA proposal will increase the cost of insured A&H coverage, particularly for long-term disability benefits. A move away from insured coverage poses a genuine threat to the security of those becoming disabled after the QRA proposal would take effect.

Implementing the QRA proposal would be an administrative nightmare. This flies in the face of the Administration's expressed purpose of simplifying tax calculations.

The GAO proposes to delay the unpaid loss deduction by permitting the insurer to deduct, in the year it sets up a loss, only the present value of that loss. The GAO would compute that present value by discounting the full amount of the loss over the insurer's projected time-to-payment. The discount rate would be based on a 5-

year moving average of each company's pre-tax net return on its investment portfolio.

Unlike the QRA, the GAO proposal would allow subsequent deductions for the additions to the liability as it built up from its discounted value to the full amount.

Since the GAO proposal employs discounting, its implementation requires advance knowledge (or at least good approximations) of the times an insurer's losses will be paid. However, because the timing of estimated payments fluctuates considerably, it cannot be known with accuracy. Yet, under the mechanics of the proposal, a company would be penalized for overestimating the length of time until payment of a claim.

The GAO proposal also would produce disparate tax results for otherwise similar insurers that incurred the same losses but experienced different rates of return.

The insurance industry has repeatedly underestimated its longer-term losses, a problem exacerbated by economic and "social" (jury award) inflation. However, under the mechanics of the proposal, a company would be penalized for such underestimation. While the GAO proposal may be sensible for transactions that do not involve risk (such as simple deposits held at interest), its application to risk-pooling activities is off the mark.

The GAO proposal would introduce considerable additional complexity into the tax system. All of these defects led the Treasury Department to reject such discounting in public testimony in early 1984.

Enactment of either the QRA or the GAO proposal would exacerbate the existing "capacity" problem, impede economic recovery, and aid foreign competition.

Recent operating losses have heavily drained the property and casualty insurance industry surplus. Since an insurer's ability to write coverages is limited by a ratio of premiums to surplus, insurance "capacity" is falling short—by an estimated $62 billion in coverage over the next three years.

The availability of economically priced insurance coverage is vital to the operation of American businesses. Where such coverage is not available from the private sector, the government must enter the insurance market to provide the needed protection.

Adoption of the QRA or GAO proposal would add to the surplus drain, worsening the capacity problem and threatening the availability of coverage for a large segment of American business.

Adoption of either proposal could also entice foreign competitors to step up their efforts to make inroads on American companies' share of the international insurance market. And it could encourage insureds in the U.S. to place their coverage overseas, adding to balance-of-trade difficulties.

Mr. Chairman, CIGNA believes that there is room for improvement of our tax laws. Congress properly should review the Internal Revenue Code from time to time. This does not mean it should revise the life insurance tax reform it passed last year.

Congress regularly should seek to improve tax fairness, increase simplicity, and encourage economic growth. However, certain of the insurance proposals advanced by the Administration would not contribute to these goals, and indeed, would have undesirable effects. The proponents of these changes have ignored sound social policy judgments woven into the Internal Revenue Code by Congress.

The Congress should recognize that insurers—life, health, property and casualty—are the institutions that privately capitalize and administer the American system for furnishing economic protection against current and future hardships. Congress is a partner in the system through the tax laws. In its absence, the public would demand that government devise, fund, and administer replacement programs.

Consider the insurance services suggested for "tax reform" treatment and the social purposes they serve:

Permanent life insurance provides survivor protection at affordable prices.

Retirement benefit plans and deferred annuities provide old-age security.

Employer-provided health insurance provides health care to 162 million Americans.

Property and casualty insurance companies provide economic protection to individuals and businesses that could be wiped out financially, should they fall victim to injury or loss.

Each of these insurance services is important and meets valid social and economic goals.

To reduce or eliminate existing tax incentives may ultimately reduce the ability of Americans to remain free of government dependence. Equity does not demand that we level a system that provides incentives for self-reliance. Rather than viewing equity as demanding that all be reduced to the lowest common denominator, Congress should seek equity by creating new and innovative incentives to promote greater self-sufficiency.

Changes to existing tax rules inevitably will alter the ability of the industry to provide services as it does now. This is a substantial risk for the federal, state and local governments.

Insurers, needless to say, try to consider all risks in devising policies. We urge Congress to do the same.

STATEMENT OF THOMAS R. ANDERSON, CHIEF EXECUTIVE OFFICER, KEMPER INVESTORS LIFE INSURANCE CO., CHICAGO, IL

Senator BENTSEN. Mr. Anderson, would you proceed, please.

Mr. THOMAS ANDERSON. My name is Thomas R. Anderson, and I am chief executive officer of Kemper Investors Life Insurance Co.

Today I appear before you on behalf of the Committee of Annuity Insurers, which is a coalition of 27 of the Nation's leading annuity underwriters. While I deeply appreciate the opportunity to present the comments of the annuity group, in all candor I am surprised that the need for my appearance here today has followed so closely on the heels of my last appearance before this committee less than 2 years ago on the same subject. Namely, the taxation of life insurance products and policyholders.

That hearing was an integral part of the long process during which the 98th Congress fashioned a wholesale reform of the tax treatment of life insurance companies and their products. Now fewer than 6 months after many of the annuity reform provisions in the 1984 act became effective, and just 2 years after the TEFRA changes were enacted, the administration is proposing even further changes.

Under the administration's proposal, an annuity policyholder would be taxed currently on the interest credited to his contract, even though he has not received these amounts. The policyholder would be put in the position of paying a tax on income he cannot effectively receive, assuming he wants to retain the basic benefit he acquired when he purchased the annuity.

The policyholder would incur ongoing negative cash flow for the privilege of purchasing the annuity. Not only does this represent a fundamental change in the taxation of insurance products, it is contrary to both sound tax policy and sound social policy.

If enacted, it would very likely tax out of existence one of the best retirement products that is presently available to the American consumer. And as a result, in no way would this proposal raise anywhere close to the $1½ billion figure quoted by the Joint Committee on Taxation.

In 1982 and 1984, Congress made substantial changes to the tax treatment of annuities in order to ensure that such contracts are used primarily for long-term savings and retirement purposes. We believe that those changes have achieved their desired result.

If consumers don't buy annuities, it is unlikely that they will shift that money into other taxable savings vehicles on a long-term basis. In other savings vehicles, funds are easily assessible to consumers and are likely to be short term as compared to annuities. The diversion of savings to such instruments is unlikely to generate substantial tax revenue, and almost assuredly will not create the long-term savings pool that is created by annuities.

I must reiterate that the annuity contract is not a tax avoidance device. The premiums for a nonqualified annuity are paid for in after-tax dollars. Furthermore, current law does not allow interest on annuities to escape tax. It only permits the deferral of tax. All income credited to the contract is eventually taxed at ordinary income tax rates when money is actually received by the policyholder.

The administration has argued that taxing the inside build up on annuities and life insurance contracts is necessary in order to ensure that such contracts are not accorded more favorable tax treatment than savings instruments with other financial intermediaries. The premise of the administration's line of reasoning, that annuities are essentially no different from bank savings accounts, is entirely faulty. In contrast with savings deposited in a bank, the purchase of an annuity confers on the policyholder the guarantee that at retirement these savings will be returned in the form of a stream of payments that will continue for the balance of his life.

In addition, the administration has totally ignored the role that deferred annuities play in individual retirement planning. There is no doubt that annuities serve a valuable social function in ensuring that individuals have adequate income during their retirement years. While IRA's and qualified pension plans are an important vehicle for saving for retirement, they do not nor can they, meet every individual's needs. And as I have already pointed out, because annuities are purchased with tax-paid rather than tax-deductible dollars, existing tax treatment of annuities is far less favorable than that accorded IRA's or 401(k)s. Indeed, it is a very modest incentive to individuals who are genuinely concerned about the adequacy of their retirement income.

It bears repeating that unlike other retirement products, only the annuity can provide an individual with income for life, income that an annuitant cannot outlive. It is beyond comprehension why this administration should seek to discourage this kind of financial independence. I sincerely hope you gentlemen will not permit that to happen.

Thank you.

Senator BENTSEN. Thank you very much, Mr. Anderson.

[The prepared written statement of Mr. Thomas Anderson follows:]

STATEMENT OF
THOMAS R. ANDERSON
ON BEHALF OF
THE COMMITTEE OF ANNUITY INSURERS

Mr. Chairman and other distinguished members of the Committee, my name is Thomas R. Anderson, and I am Chief Executive Officer of Kemper Investors Life Insurance Company. Our home office is in Chicago, Illinois. I appreciate this opportunity to appear before you today to present the views of the Committee of Annuity Insurers on the President's "Tax Proposals to the Congress for Fairness, Growth, and Simplicity" (the "Administration Proposals") and, in particular, on the Administration's Proposal to alter the tax treatment of nonqualified deferred annuity contracts.

The Committee of Annuity Insurers, a coalition of 28 of the leading annuity writers in the country, was formed in 1981 for the purpose of monitoring legislative and regulatory issues at the Federal level that affect annuity policyholders and annuity writers. In 1984, member companies of the group accounted for almost 1/3 of the total annuity premium volume in the United States. A list of the member companies of our coalition is attached.

Mr. Chairman, while I deeply appreciate the opportunity to present to you the comments of the Annuity Group, in all candor, I am surprised that the need for my appearance here today has followed so closely on the heels of my last appearance before this Committee less than two years ago on the same subject -- the taxation of life insurance products and policyholders. That hearing in January of 1984, was part of the long, complex and arduous process, during which the 98th Congress fashioned a wholesale reform -- and I must emphasize the word reform, for it was genuinely that -- of the provisions of the Internal Revenue Code relating to the taxation of insurance companies and life insurance products, including nonqualified annuities. As respects deferred annuities, a combination of the 1984 Deficit Reduction Act and related provisions of the Tax Equity and Fiscal Responsibility Act of 1982 significantly altered the applicable tax rules, in ways that ensure that nonqualified annuity contracts in fact are used to provide retirement income.

Now, less than a year after many of the annuity reform provisions included in the Deficit Reduction Act became effective, the Administration is proposing further changes in the taxation of annuity products and annuity companies. Many of these changes were specifically considered, and rejected, by the Congress just last year. While we support the Administration's overall goal of tax reform and tax simplification, we believe that, even in the context of overall tax reform, additional changes in the taxation of insurance companies and insurance products are not needed. In general, we share the concerns expressed in the statement of the American Council on Life Insurance on the insurance provisions in the Administration Proposals. However, we wish to limit our comments to one aspect of the Administration Proposals -- the proposal to tax the so-called "inside build-up" on deferred annuity contracts.

Under the Administration Proposals, an annuity policyholder would be taxed currently on the interest credited to his or her annuity contract (the so-called "inside build-up") even though the policyholder has not received these amounts either directly or constructively. Thus, under the Proposal, the policyholder would be put in the position of paying a tax on income he cannot effectively receive -- assuming he wants to retain the basic benefits he acquired with the purchase of his annuity. The policyholder would incur ongoing negative cash flow (because of the tax he would pay) for the privilege of purchasing the annuity. Not only does this Proposal represent a fundamental change in the taxation of insurance products, it is contrary to both sound tax policy and sound social policy. If enacted, it would very likely tax out of existence one of the best retirement products that is presently available to the American public. The reasons advanced by the Administration in support of its Proposal are neither compelling nor convincing. In 1978, and again in 1983-1984, Congress had before it similar proposals to tax the inside build-up on annuity contracts. Both times these proposals were rejected. This Congress should do likewise.

To comprehend fully the Proposal currently being advanced by the Administration, it is essential that we clearly understand the present state of the tax law regarding nonqualified annuity contracts and how we arrived at the current tax treatment. First of all, the annuity contract is not a tax avoidance device. The premiums for a nonqualified annuity are paid in after-tax dollars, that is, such premiums are not deductible from gross income. Furthermore, current law does not allow interest on annuities to escape tax -- it only permits a deferral of tax. All income credited to the contract is eventually taxed at ordinary income tax rates when money is actually received by the policyholder. Ordinary income tax rates apply even though, in the case of variable annuities, a portion of that income may have been generated from long-term capital gains.

In 1982 and 1984, Congress, after exhaustive review, made substantial changes to the tax treatment of annuities in order to ensure that such contracts are utilized for long-term investment and retirement purposes. As a result of these changes, if a policyholder makes a premature withdrawal from an annuity contract, the amount withdrawn is considered to come first from gain that has accrued under the contract, until all such gain has been taxed. In addition, with limited exceptions, a penalty tax of five percent is imposed on withdrawals from a deferred annuity that occurs before the holder has reached age 59-1/2. For these purposes, a loan against, or pledge of, the annuity contract is treated as a taxable distribution. Furthermore, to curb any potential for continuing deferral of tax after the death of the annuity policyholder, a provision was added in 1984 requiring (except in the case of a transfer to a surviving spouse) that distributions under the contract, which operate to terminate any tax deferral, be commenced at the time of the policyholder's death. In addition, the Technical Corrections Act of 1985, which is currently pending before this Committee, would expand these "forced distribution" rules to include transfers by gift as well as by reason of death.

Our experience has shown that the changes enacted in 1982 and 1984 ensure, as the Congress intended, that annuities will be used for their basic purpose -- to provide for the long-term retirement needs of the American people. Hence, the fundamental objection to deferred annuities raised by the Administration in its tax reform proposal -- that they can be used like a bank savings account to shelter short-term savings -- has already been addressed by Congress. The Administration, which supported the 1982 and 1984 revisions, has presented no evidence that additional changes are needed at this time.

In support of its Proposal, the Administration does argue that such taxation is necessary to ensure that annuity contracts are not accorded more favorable tax treatment than "savings" instruments with other financial intermediaries. Otherwise, according to this line of argument, the flow of "savings" dollars will be directed to life insurance companies and away from other financial intermediaries.

Mr. Chairman, the premise of the Administration's line of reasoning -- that annuity contracts are essentially no different from bank savings accounts -- is entirely faulty. In contrast with savings deposited in financial institutions, the purchase of a deferred annuity also confers on the policyholder a guarantee that, at retirement, these savings, plus interest, will be returned to the policyholder in the form of a stream of payments that will continue for the balance of his or her life. The decision by Congress to impose a penalty tax on pre-retirement withdrawals from a deferred annuity operates to ensure that annuity contracts will in fact be held until the time of retirement. These considerations operate as a deterrent to the purchase of annuities for purposes other than retirement, and significantly undermine the Administration's unsupported apprehension that preservation of the existing tax treatment of annuities will divert non-retirement savings to annuity companies from other financial intermediaries. Indeed, the Administration has offered no convincing argument to the contrary and has not presented any evidence demonstrating that other financial intermediaries have experienced a decline in deposits due to annuity sales.

In its Proposal, the Administration has also argued that the current tax treatment of annuities favors wealthy individuals, since such individuals have more disposable income available for savings. Such "reasoning", however, totally ignores the fact that wealthy individuals can achieve much greater rates of return and tax preferences from other "investments", such as, for example, municipal bonds.

Finally, the Administration has totally failed to anaylze the role that deferred annuities play in individual retirement planning. In this connection, the Proposal is especially noteworthy for what it fails to say. There is no doubt that annuities serve a valuable social function in ensuring that individuals have adequate income during their retirement years. Mr. Chairman, one of the greatest fears expressed by our customers -- both old and young alike -- is the real or anticipated inability of social security (1) to keep pace with inflation for those already retired, and (2) to provide any benefits at all for those whose current contributions are being counted on to carry the system. As recent events have shown, a financially sound social security system alone cannot ensure that an individual's retirement years will be free from financial worry. It is critical, then, to support savings programs which bridge the gap between social security benefits and an adequate retirement income.

While Individual Retirement Accounts ("IRAs") offer an important supplement to personal savings for retirement, they do not, nor can they, meet every individual's needs. For example, during their early working years and their family-rearing years, many middle income individuals are just not financially able to set aside $2,000 each year in an IRA. As a result, the funds they ultimately contribute to an IRA, beginning at age 45 or 50, will not provide sufficient retirement income. That same individual could, however, purchase an annuity contract at age 50 and still be assured that he or she will have adequate retirement income. With an annuity, an individual is guaranteed that he or she can receive periodic payments for life, thereby offering a way of eliminating the risk, and the fear, of out-living one's resources. The reason that only with an annuity can an individual be guaranteed lifetime income is that such a guarantee involves the assumption by the insurance company of substantial mortality risks for years into the future. While banks may guarantee specified interest rates, they cannot make lifetime guarantees. Because of this, the annuity has been characterized as the most certain, convenient, and complete protection against dependency available to an individual today. And, as we already have pointed out, because annuities are purchased with tax-paid, rather than tax-deductible, dollars, existing tax treatment of annuities is far less favorable than that accorded IRAs. Indeed, the tax deferral present in a deferred annuity is a very modest incentive to individuals who are genuinely concerned about the adequacy of their retirement income.

Rather than discouraging savings through annuity contracts by adopting the Administration's Proposal, Congress should act to preserve the incentive to retirement saving through such socially desirable arrangements. This is especially appropriate since, like other life insurance products, annuities play an important role in our nation's economy as a source of investment capital. Through the end of 1983, for example, life insurance companies had invested over $150 billion in all forms of investment, thereby placing life insurance companies fourth among all private domestic institutional sources of funds. Taxing the inside build-up on annuity contracts would curtail the availability of such funds for long-term investment and would significantly impede capital formation.

CONCLUSION

The Committee of Annuity Insurers urges this Committee to reject the Administration's Proposal to tax the inside build-up on annuity contracts. The current basic tax treatment of deferred annuity contracts -- which has prevailed since 1913 -- is grounded in sound tax and social policy. A policyholder should not be taxed currently on income he or she has not received, either directly or constructively. As a matter of social policy, the reasons for the traditional taxation of annuities have not diminished with time. In fact, today more than ever we as a Nation need to encourage individuals to provide for their own security in their retirement years. For many, the annuity provides an essential supplement to public and private pension plans. For others, it provides the only source of retirement income outside of social security. The annuity contract must be allowed to survive.

October 1, 1985

COMMITTEE OF ANNUITY INSURERS

Aetna Life & Casualty Insurance Company
Allstate Life Insurance Company
American General Life Insurance
American National Life
Anchor National Life Insurance
Capital Life Insurance Company
Capitol Holding Corporation
Charter Insurance Group, Inc.
Church Life Insurance Corporation
CIGNA Insurance Companies
Equitable Life Assurance Society of the United States
Family Life Insurance Company
Fireman's Fund Insurance Company
Guardian Life Insurance Company of America
Hartford Life Insurance Company
IDS Life Insurance Company
Integrated Resources Life Companies
Kemper Life Insurance Companies
Keystone Provident Life Insurance Company
Life Insurance Company of the Southwest
National Benefit Life Insurance Company
Nationwide Life Insurance Companies
New England Mutual Life Insurance Company
New York Life Insurance Company
Northwestern National Life Insurance Company
Sun Life of Canada
The Manufacturers Life Insurance Company
The Travelers Insurance Companies

September, 1985

STATEMENT OF JOHN P. MASCOTTE, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, CONTINENTAL CORP., NEW YORK, NY, ACCOMPANIED BY DEAN O'HARE, EXECUTIVE VICE PRESIDENT, THE CHUBB CORP.

Senator BENTSEN. Mr. Mascotte.

Mr. MASCOTTE. Senator Bentsen, I'm John Mascotte, chairman of the board and chief executive officer of the Continental Corp. Joining me here today is Dean O'Hare, executive vice president of the Chubb Corp. The Chubb Corp. and Continental are jointly submitting my oral remarks as well as a submitted written statement, which I will give you at the end of my comments.

I would like to return, Senator, if you don't mind, to a subject discussed rather extensively this morning in the first panel. And that is the issue of the consolidation of property and casualty companies. And rather than simply read my statement and that of Mr. O'Hare's into the record, I would like to simply submit that to you and respond to a couple of the objections that earlier testimony has elicited.

Senator BENTSEN. We will be happy to have it for the record.

Mr. MASCOTTE. Thank you very much.

There are really two questions that appear to surface as the objections, the principal objections, to eliminating the consolidation of property/casualty companies with both nonlife companies and life companies. The first of those is that somehow property/casualty companies should not be singled out for exclusion from the benefits of consolidation since other entities are allowed to consolidate.

I would like to point out to the members of the committee what the whole principle of tax consolidation is based on the premise that entities which otherwise could be branches of a single organization but which might choose to be separately incorporated to create limited liability or to meet the needs of an individual State's jurisdictional limitations operate—those principles of consolidation operate to allow for tax purposes the aggregate of similar entities.

By definition, property and casualty companies aren't such entities. They are required by State law to be separately incorporated and separately regulated. And, indeed, they are equipped, as you have already heard this morning, with a very conservative accounting system that focuses on balance sheet strength in order to assure policyholder solvency. Since those entities are different, we believe they, by definition, should not, therefore, be seen as just like other companies, and therefore made eligible for consolidation with other non-PC entities.

The second significant objection that we have heard to the proposal we have made to eliminate consolidation of property/casualty companies goes something like this: "Gee, yours is a cyclical business. The only reasom that you have generated all these losses that are now being used by non-PC companies is that you are at the end of the cycle. And since that's a pretty predictable pattern that profits will improve and you will move into a taxable position again anyway, why, in essence, create a long-term solution to a short-term problem."

The answer to that question is really an interesting one because it tends to lie in a shift that has occurred in our industry since consolidation was allowed. The truth of the matter is that as interest rates rise and the conservative concept of accounting that the statutory accounting that we use in our system—what has happened is that the property/casualty industry, in essence, has become a tax shelter. The nature of the accounting conservancy, in effect, makes it possible for us to constantly gin up, as many members of the committee have already asked of earlier participants today—constantly makes it possible for us to gin up tax losses.

We think the necessary conservancy needed in order to maintain shareholder surplus and solvency in the industry makes the accounting system an attractive one and a fair one for the industry. But we would like to point out that that does not mean that those tax advantages then ought to be drained off from the property/casualty industry and made available to the life insurance industry or any other industry.

In our view, it is frankly rather unlikely unless we see a dramatic decline in interest rates that, in fact, property/casualty companies will fall back into a taxable position, if you continue to allow us to use the regulatory—the statutory accounting rules. That being the case, if, in fact, this industry is going to tend to generate substantial tax losses, those ought to be contained in this industry to make sure that those benefits are not drained off to affect others that you all did not intend to benefit in that manner.

Let me summarize very quickly by saying that we are—both the Chubb and Continental are—for paying our fair share. And we would be more than happy to work with the committee in establishing a fair system of taxation for the property/casualty industry. But in doing so, please, let's start from a level playing field. And we think that if you eliminate consolidation, you, in fact, will create a level playing field and at the same time generate substantial additional revenues. We estimate as much as $1 billion in 1986 could be achieved by the elimination of consolidation.

I would like to note in passing that both the Chubb and the Continental would be affected negatively in that sense by the proposal we are making because we are both in the life insurance business as well as the property/casualty business, and, indeed, we would pay more taxes if you accept our proposal than we would if you don't accept this change.

Thank you very much.

Senator **Bentsen**. Thank you very much.

I have a hunch that Mr. Lebed would enjoy that kind of a debate with you. I wish we had more time for it.

Mr. **Lebed**. I would very much.

Senator **Bentsen**. What concerns me, and the statement has been made here, that the life insurance industry has had, I guess, over the last 3 or 4 years three different tax laws and now they are talking about a fourth. There is one thing that business has to have and that is some continuity as to the type of taxes that they are being subjected to.

And we went a long way last year, as I recall, in trying to cut out some of the differences, different ways, that life insurance companies are treated from regular corporations, other types of corporations, as far as some of their deductions and that type of thing.

And then we concentrated very heavily on those kinds of policies that were structured as truly investment vehicles, and zeroed in very much on economic income.

So I must say I have some concern. I share the feeling that we have a real problem on long-term capital in this country, and it is becoming more and more scarce. And that's true as we deregulate banks, and we are doing a great deal of that to the S&L's. You have got a lot more hot money involved.

And so where do you go for the long-term money? You go to a life insurance company. And I don't want to see that source dry up. And that's what concerns me about the inside buildup. Not just looking after you folks, but looking after the country as a whole. That's what concerns me much more, in all candor.

One of the Ways and Means options—Mr. Anderson, I think you addressed it—concerns deferred annuities and the inside buildup there. Now, as I recall, individuals have a $100,000 safe harbor in that situation. But they are apparently talking about treating corporate deferred annuities different from individuals. How many of them are bought by corporations, and how can they justify treating one different from the other.

Mr. **Thomas Anderson**. I do not have any specific statistics with regard to the corporate clients buying annuities, but I've got to believe it's a very, very small percentage of those annuities that are sold. The $100,000 dollar limit, of course, that you were referring to is the Ways and Means proposal. I, frankly, think it is quite arbitrary. No. 1, if somebody should buy an annuity late in life and use up his $100,000, and I would point out that most annuities are bought by people in their 50's, you can go through the mathematics and determine whether you think you can live on what that $100,000 might yield. Now maybe the $100,000 will work for a 22 year old if he has enough money to buy a $100,000 annuity. With a compounding interest, it would probably work. But it's an arbitrary number that has to be thought out a lot more than that. Plus, it is still, in a limited way, taxing the inside buildup. And beyond that, also, it is not even fair compared to some of the rules with regard to limitations on corporate retirement plans where really you can accumulate much more than that.

That aspect of the Ways and Means Committee proposal, I think, takes a lot more discussion. Our group has not had time yet to discuss that, although we will very shortly. But I think that is a real trap that has to be looked at very carefully.

Senator **Bentsen**. Thank you.

Mr. Beck, we heard Mr. Phillips in the last group talking about 401(k)'s and the repeal by the administration, requested by the administration, on employer-sponsored savings plans. They would emphasize instead IRA's and spousal IRA's. Do you think—how do you evaluate the IRA as compared to the 401(k)? And would you give me your feelings about the proposed repeal of 401(k) and why?

Mr. **Beck**. Yes, Senator, I would be glad to. I have been a part for several years, as I think you may know, of several other studies dealing with the whole concept of pension policy in the United States. And I think that the IRA program is going to continue to build. It may happen a little slowly now. I think that the 401(k)'s, absent legislation that would tear the heart out of it, will continue to grow. I would suggest that as some evidence of this in my own company going back 15 years now we have had a thrift plan, and that thrift plan permits an employee to get a contribution of 3 percent from us, if he puts in 3 percent. And the employee can put in an additional 10 percent.

For the last several years, our employees have averaged savings of slightly over 10 percent, including the company 3, in every category of salary except people, a small number of people, making less than $10,000 a year. And their savings rate has been 9.7 percent. Now I believe these savings are not transfers from other savings programs. I believe they are totally new savings. And a great deal of it comes about because of the concept of, first, the payroll deduction, and they don't pay taxes on the investment earnings of those moneys until such time as they draw it down.

But it's regarded by our own employees as even more popular than our retirement plan. So I suggest, sir, just to make this one observation—that's 15 years. It takes a long time to change behavior. It takes a long time for people to change basic attitudes. And I believe that the IRA's and the 401(k)'s are going to continue to grow in future years doing a lot more for savings than has been done thus far.

Senator **Bentsen**. I see my time has expired. Thank you very much.

Senator **Matsunaga**. I believe Senator Bradley has come in.

Senator **Bradley**. Thank you, Mr. Chairman. I will just ask one brief question.

I'd like to ask the panel—most of the testimony dealt with the Treasury proposal, and I was curious as to what you thought of the Ways and Means proposal as it relates to insurance. I mean from the standpoint of inside buildup. That problem was resolved. And I think some of the other problems. So I would be curious if you would comment on the Ways and Means proposal as it affects the insurance industry. And you might, since I have a sense of what you might say—also give special attention to the question of policyholder loans and partial withdrawals.

Mr. **Lebed**. Would you like me to start?

Senator **Bradley**. Yes, if you would.

Mr. **Lebed**. I would make a comment in three different categories. In the area of life insurance, obviously, we welcome the abandonment of the idea of taxing the inside buildup and the abandonment of the idea of changing the way life insurance reserves are taxed. I agree with testimony given here earlier that the proposed taxation of policy loans as if they were income is just as onerous as taxing the inside buildup, if not more so. It would have all the same negative impacts. It would be very, very distasteful to us.

In the property and casualty area, we are pleased to see the QRA concept abandoned. But as many others here have testified, we think the aggregate of alternate proposals would be at least as bad if not worse than what was in the administration's proposal. And that has been discussed in great detail.

The last point I would like to comment on is the new proposal to repeal the special deduction for life insurance companies. Here's what that is. After all other income calculations are made, taxable income is reduced by 20 percent before the corporate tax rate is applied. Now if you repeal that, in effect, it would be increasing life insurance company taxes by 25 percent, which is obviously a very, very major increase. When that special deduction was created last year, I think there were two very important issues. One was to recognize the long-term nature of the life insurance industry. You might think you know what profits you made this year, but actually it will be many years before you really know. And I think a good case in point is what the future holds for the life insurance industry losses related to this new disease, AIDS, that has everybody so concerned. I think that's a good example of the unpredictable nature of our business.

Second, the special deduction was intended to create interindustry balance between the taxes paid by us and by other financial institutions. And I believe it was perceived that this was accomplished. Now if taxes are changed for other competing industries in a way that disturbs that balance, then it's not unreasonable to take another look at our taxes and our special deduction. But in the absence of that, we feel very strongly that the special deduction should be preserved exactly the way it was enacted a year ago.

Senator **Bradley**. Mr. Anderson.

Mr. **Thomas Anderson**. I would second most of what Mr. Lebed just said, and I will not repeat all the same things.

Senator **Bradley**. OK. Thank you.

Mr. **Thomas Anderson**. I spoke a moment ago about the $100,000 cap that the Ways and Means Committee has introduced. Although we are very thankful that they are throwing out the administration's proposal on inside buildup, again, that $100,000 limitation is one that has to be carefully examined. And one further point that I did not make previously on that is again that the deferred annuity, the nonqualified annuity that we underwrite, is paid for with after-tax dollars. That is a distinction that exists that should not be ignored when it is compared to any other type of retirement vehicle.

Senator **Bradley**. Do you agree with Mr. Lebed that the loan provision is as damaging as inside buildup?

Mr. **Thomas Anderson**. I think it's damaging. I would not say it is as damaging because the inside buildup issue essentially eliminates whole life insurance and deferred annuities, and that is the most serious thing within any of the proposals.

Mr. **Mascotte**. Senator Bradley, I would join both Mr. Lebed and Mr. Anderson in overwhelmingly expressing the Continental and the Chubb's pleasure in the elimination of the inside buildup. And I think I probably stand fairly close to Mr. Anderson's analysis of a comparison of that with the taxation, the proposed taxation, of policy loans. Not perhaps as damaging as the inside buildup or as fatal, but certainly not a very attractive way of raising revenue and building these kinds of adjustments.

Those would be my only comments with respect to the life side. On the property/casualty side, we note with some interest that the Ways and Means Committee includes an elimination on the issue, again, of consolidtion that I spoke to. And elimination of 65 percent of the capacity of offsetting P-C losses in non-P-C company affiliates. We think that's only a partial solution, frankly. That if something ought to be eliminated, you don't eliminate 65 percent of it; you go all the way and create a real level playing field by eliminating 100 percent of the loss carryover potential.

Those would be my only comments on the PC side.

Mr. BECK. Senator Bradley, I would share the reactions of the others on the inside buildup and the reserve treatment. I think that was the very appropriate conclusion to reach.

I find it very hard to understand the recommendation about policy loan interest. I do not put that in the same magnitude as the inside buildup. I find it hard to understand why this should be treated differently than other interest and put in a special category. I am concerned about preliminarily too soon dismissing the TIA 20-percent "hair cut." That was designed to be sure we were paying as an industry the appropriate level of taxes. I think at the very least we should wait until we see what the whole package is to try and determine if anything further is needed as a contribution from the industry rather than just eliminating this 20 percent.

Senator BRADLEY. Thank you very much.

Senator BENTSEN. Senator Matsunaga.

Senator MATSUNAGA. Thank you, Mr. Chairman.

Mr. Mascotte, in your opposing the existing consolidated return, is it fair to conclude that you are saying that the present system is forcing PC insurance companies into mergers with life insurance and other noninsurance companies?

Mr. MASCOTTE. I don't think there is much question about that, Senator. If you take a look at the largest property/casualty companies in the last 10 years, you will notice that over half of them have now wound up either affiliated with a life insurance company or being acquired by a noninsurance parent. And the reason for that, again, as I mentioned in my earlier testimony, now that our industry is capable of producing substantial tax shelters, assuming you allow consolidation to continue, those shelters are going to find an outlet in some nonproperty/casualty entity. And, clearly, the most effective way of achieving that is to create either mergers or acquisitions, which will have, I think, the effect of the elimination of independent PC companies.

Senator MATSUNAGA. Is your company involved in PC as well as life?

Mr. MASCOTTE. Oh, yes. As a matter of fact, we are more involved in property/casualty. We are, frankly, starting life operations because as a defensive measure under the theory that if we can't beat them, we've got to join them. We are, in effect, going to have to build our own non-PC income.

Senator MATSUNAGA. But with your experience in both, is it not evident to you that PC's and life are different, especially in projection of what your liabilities are going to be?

Mr. MASCOTTE. I think a number of witnesses here today have provided ample testimony to the fact that predictability is very difficult to assure in the property/casualty business. Not just because of catastrophes, but because of shifts in judicial awards, et cetera. I think predictability in terms of acturial predictability is now much easier to achieve on the life insurance side. So there is not in effect a similar predictability.

Senator MATSUNAGA. Well, my concern, of course, as with other members of the committee, I am sure, is how much more will the insured be paying if we do away with consolidated return for PC insurance.

Mr. MASCOTTE. Well, Senator, I'm not so sure that you could draw any inference on pricing either lower or higher. I suppose you could make an argument either way. I think pricing in the property/casualty industry tends to flow more from overall competitive factors. When there is a segment of the industry that has a tax advantage through consolidation over its competitors, that may lead either to an attempt to enlarge market share by crowding out others or keeping prices artificially low for a period of years in order to disadvantage those that don't have an ability to offset those prices, those tax losses.

What you clearly see, I think, is a real attempt in the last 10 years to prolong cycles by using tax losses in consolidating transactions. And I think that's one of the reasons you are seeing a rather violent swing today in both pricing and in capacity. We are being accused as an industry today, ironically, by statutory regulators of not having enough surplus. Perhaps by some here in Washington, assuming we have too much surplus, and therefore we ought to have some of the tax, and at the same time not providing adequate markets. And it is awfully difficult to rationalize capacity in our industry. And I think one of the reasons for that is that tax loss utilization by only a portion of the industry is exacerbating the cyclical swing.

Senator MATSUNAGA. Industrywise, your views would be minority or majority?

Mr. MASCOTTE. Well, that's an interesting point. I think if you took the total number of companies in the industry, you would find us rather substantially in the majority. If you take the number of entities that are already doing a substantial amount of non-PC business, either life or nonlife, there is no question we are a decided minority.

Senator MATSUNAGA. Thank you, Mr. Mascotte.

I have a question for Mr. Beck. As you know, the administration proposed the elimination of the 401(k), deferred compensation plan, in Treasury I, and reinstituted a modified 401(k) program in Treasury II, and has proposed, again, elimination obstensibly for revenue purposes. In your view, what is the key advantage of 401(k) plans over the administration's chosen vehicle for retirement savings; that is, IRA? And does it effectively encourage new savings?

Mr. BECK. Sir, I do believe, Senator, that it does produce new savings. And I think it will do more and more so over time as more companies implement plans, provided they begin to see a tax atmosphere around that suggests that they don't introduce a plan and immediately find that it no longer has the tax advantages originally perceived.

People do put more and more money into plans like this, especially with payroll deduction systems. We do need that kind of capital. As Senator Bentsen suggested in some of his earlier comments where he was so concerned about capital being available, this is a major way of accumulating capital where people believe they do it on a painless, gradual way and they will make those contributions.

Senator MATSUNAGA. Thank you very much.

Mr. Lebed, I'm going to let you extend your remarks in response to Mr. Mascotte stating he represents a majority viewpoint. But we do have to close these hearings.

Mr. LEBED. I have probably shown my discomfort, so I appreciate this very much. Let me just say briefly that my company, the CIGNA Corp., which is a multiple line company, would want to be on record as stating that the proposal to completely eliminate property and casualty consolidation would be grossly unfair discrimination against property and casualty companies. In fact, the present restriction on consolidation with life companies is unfair discrimination.

To support my position let me just tell you the experience of my own company in 1984. On gross revenues of roughly $4 billion in our property and casualty operations, we had underwriting losses of roughly $1 billion. We had investment income of roughly $600 million, for a net bottom-line loss of $400 million. And if that were the loss of a free-standing company, we would have been in serious trouble. Fortunately, because of the combined company, we infused into the property and casualty operation over half a billion dollars of new capital to keep that operation very strong, vibrant and healthy, which is certainly in the best interest of our policyholders and the public generally. Clearly, we were and we behaved as a single economic unit, which is the foundation for the principle of consolidation.

When all of that settled down and we figured out our consolidated results, we had a small gain on our bottom line. But our income taxes were $71 million on income of $142 million, for an effective tax rate of 50 percent, which is in excess of the maximum corporate rate of 46 percent.

I believe several other multiple-line companies had effective tax rates in the 70-percent range.

Senator MATSUNAGA. Thank you very much.

Both of us have a meeting we are supposed to be attending. And I might say, gentlemen, that the one thing you probably ought to work on is an actuarial table on tax laws to see how long they are going to stay on the books. [Laughter.]

Thank you very much.

[Whereupon, at 12:45 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

AMERICAN ACADEMY OF ACTUARIES
1835 K STREET, N.W • SUITE 515 • WASHINGTON, D.C 20006 • (202) 223-8196

September 30, 1985

The Honorable Bob Packwood
Chairman
Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

The American Academy of Actuaries Committee on Life Insurance has been asked to furnish the Committee with comments on the portion of the Administration's proposal (The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity) dealing with the life insurance company reserve deduction.

The American Academy of Actuaries is a professional association of actuaries involved in all aspects of actuarial work. It is not an industry association. Its purpose in making these comments is to address solely the actuarial aspects of the life insurance company reserve provision, and the premises which underlie it. It does not intend to deal with questions of tax policy, leaving those instead for debate among the Congress, the companies affected, and other interested parties.

The Proposal

The Administration proposes that, for purposes of computing taxable income, the life insurance reserve for any contract be limited to the cash surrender value of that contract, adjusted for any surrender charge or penalty.

The Premises

The proposal appears, based on Chapter 10.08 of the General Explanation, to rest on the following premises:

1. The premium for any non-term life insurance policy can be divided into a loading component, a term insurance component, and a "savings" component. This last component serves (together with investment income earned on it) to help cover higher term costs in later years, and it is also available to the policyholder as cash surrender value.

2. The cash surrender value is an objective measure of the policy reserve because it is the amount the company will pay the policyholder to give up his rights to future benefits under the policy.

3. The provision of current law which provides for reserve deductions based on the greater of cash surrender value or policy reserve overstates the reserve deduction (especially in early years) because the policy reserve is calculated on "conservative" state regulatory requirements.

Discussion

There are several misconceptions underlying the premises on which the proposal is based. The most serious -- and the most obviously incorrect -- is the equating of cash surrender values with the reserves for policy claims and benefits. Reserves and cash values serve entirely different purposes, and failure to recognize this fact has contributed to an illogical proposal.

Policy reserves are funds set aside from current income to reflect a life insurance company's future obligations under its policies. They are amounts the company estimates it needs, along with future premium income, in order to meet those obligations. Cash surrender values, on the other hand, are policy benefits required by the insurance laws of the various states. These benefits are provided to policyholders who terminate their policies before they mature, and are set at a level designed to maintain equity between the terminating policyholders and those who continue their policies.

The fundamental distinction between reserves and cash values is clearly demonstrated by examining the legal minimum requirements for them, and by considering examples of types of insurance policies and benefits. State requirements are distinctly different for minimum reserves as compared with minimum cash values. To begin with, the interest rates and certain other factors used to calculate the two items are different. In addition, cash values are required only for certain types of policies and benefits, whereas reserves are required for all policies and benefits involving future obligations. Some examples of where cash values are not required but reserves need to be established are: most types of term insurance; many whole life insurance policies that have been in force only a year or two; and various additional benefits provided under life insurance policies such as accidental death, disability waiver of premium, and guaranteed insurability benefits. Other examples among policies and contracts issued by life insurance companies are health insurance policies and certain annuity contracts. In one instance of this type, current annuity contracts that may not be surrendered for cash, the Administration's proposal indicates that a special rule will be provided. However, in all other situations where reserves are required but cash values are not provided, the proposal would prohibit a company from properly reflecting its future contractual obligations in determining taxable income.

Another significant misconception underlying the proposal is that the legally required reserves are excessively conservative and therefore are not appropriate for measuring the "true" liability of a company for its future benefit obligations. This premise fails to recognize that in recent years the individual states have amended their reserve requirements in order to reflect contemporary circumstances. A new mortality table, the 1980 CSO Table, has been adopted. This table includes refinements to reflect various elements of risk classification such as the effects of underwriting applicants for insurance and the differences between smoker and nonsmoker mortality. Even more significant from a financial standpoint is a provision now in the valuation laws under which the interest rates used to calculate minimum statutory reserves are redetermined annually to reflect changes in the level of market interest rates.

It is clear to most actuaries that, rather than being overly conservative, current statutory reserve requirements are not sufficient to assure adequate provision for the future obligations of all companies in all situations. For example, statutory requirements may not be adequate where a company can expect higher than average mortality because of its underwriting practices. Nor do these requirements consider the potential losses resulting from investments whose maturity dates and income schedules are not well matched with benefit cash flows.

These and other potentially adverse deviations are dealt with by state requirements that a life insurer's actuary certify that "good and sufficient provision" has been made for all future obligations. The present tax law denies companies credit for necessary reserve amounts in excess of minimum statutory requirements, and further reduction of such credit would exacerbate an already troublesome situation.

Life insurance companies generally hold reserve amounts substantially in excess of the minimum statutory requirements. Furthermore, life insurers, like other companies, require capital to operate. Because of the substantial cost of writing new business, there is a continual need for additional capital to finance growth. For that reason, and because no tax credits are received, the establishment of reserves in excess of the minimum statutory requirements represents a meaningful recognition that more, not less, than the minimum is often required.

State insurance regulators are concerned that, in some instances, insurers adhering fully to legal requirements may still not be providing adequately for their benefit obligations in the reserves they are establishing. At it March 1985 meeting, the National Association of Insurance Commissioners authorized the establishment of a special task force to suggest an approach that can be used by regulators of individual states to address these concerns.

Conclusion

It is clear that the Administration's proposal to limit life insurance reserve deductions to the increase in cash values cannot be supported either by actuarial theory or by current day circumstances and practices. The proposal fails to give credit for the charges against current income that are necessary to reflect properly an insurer's future contractual obligations. We strongly urge that the proposal not be adopted.

Very truly yours,

AMERICAN ACADEMY OF ACTUARIES
COMMITTEE ON LIFE INSURANCE

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September 30, 1985

STATEMENT BY ANCHOR NATIONAL LIFE INSURANCE COMPANY IN OPPOSITION TO THE ADMINISTRATION PROPOSAL TO TAX CURRENTLY THE YEAR-BY-YEAR INCREASE IN THE CASH VALUE OF NONQUALIFIED DEFERRED ANNUITIES AND LIFE INSURANCE

Anchor National Life Insurance Company ("Anchor National") is a life insurance company organized under the laws of the state of California and admitted to conduct an insurance business in the District of Columbia and all states except New York. Anchor National has over $5 billion of life insurance in force and has approximately 17,500 insurance agents appointed and licensed to sell life insurance policies and annuity contracts.

At the end of 1984, Anchor National had written almost 125,000 deferred annuity contracts. As of July 1, 1985, the average cash value of the Company's policies was under $11,500, and the average cumulative premium received for each policy was approximately $8100.[1/] The average age of annuity purchasers was 51.7 years.

Anchor National opposes the Administration proposal to tax the year-by-year increase in the cash value (internal build-up) of nonqualified, deferred annuities and cash value life insurance. Because many other interested parties have addressed the issues concerning the taxation of life insurance,

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[1/] Unlike IRA contributions, annuity premiums are not deductible by the policyholder.

this statement will concentrate on the issues relating to annuities.

In summary, Anchor National submits that the Administration Proposal is ill-conceived for the following reasons:

-- Taxation of inside build-up would thwart the desirable goal of encouraging individuals to save for retirement. The burden of this change would fall not on the wealthy but on the middle class: as noted above, the average cash value of an Anchor annuity is less than $11,500, while the average policyholder investment is only about $8100.

-- Contrary to its stated purpose, the Proposal would not insure a "level playing field" among comparable financial institutions and products, due to the fundamental differences in function and product design, and the disparate federal and state regulation of the various types of financial institutions and products.

-- Congress has examined the taxation of annuities twice in the last three years, and has changed the tax treatment to discourage the use of annuities as short-term investment vehicles. Further changes at this time are unwarranted and unnecessary.

- Taxation of inside build-up is contrary to the principle that tax is not imposed on amounts that cannot be received without sacrificing substantial rights and benefits.
- Taxation of inside build-up would inhibit economic growth.

Historically, deferred annuities have served a valuable and meritorious purpose. That purpose -- to encourage thrift and independent planning for a financially adequate retirement income -- deserves the continued encouragement afforded by present law. The Administration tax reform proposals would reverse the historical tax deferral treatment accorded to the internal build-up in annuities since 1913.[1] If enacted, the proposals regarding the internal build-up in deferred annuities will not promote fairness, will restrict growth, and will destroy the simplicity of tax result that is a cornerstone of the President's Proposal.

A brief review of the purpose, features and current tax treatment of deferred annuities is in order. Unlike life insurance, which protects against the risk of early death, the annuity contract protects against the risk of outliving one's life expectancy and thereby exhausting one's means of support in retirement. Due to their unique function of providing a guaranteed lifetime income, deferred annuities join with social security, employer provided pension programs and IRAs to provide a safety net of retirement income. If continued and adequate encouragement is provided, deferred annuities will serve to lessen dependence upon and the ultimate pressure for ever-increasing levels of social security benefits.

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[1] The formulae for taxing annuity payments had changed periodically, but the bedrock of tax policy respecting deferred annuities has remained throughout -- no taxation while the value is accumulating in the annuity.

The deferred annuity permits the contractholder, on the basis of premiums paid during his working years, to accumulate a fund to provide income after retirement. An annuity contract can be purchased for a single premium or on a periodic premium basis. A death benefit equal to the accumulated value of the contract is typically payable to a named beneficiary in the event of the death of the annuitant prior to the commencement of the contract benefit. A loan provision is usually available. Aside from any loan provision, funds may be withdrawn from the contract only by a surrender of the contract benefits. Surrenders are subject, in many instances, to the imposition of a surrender charge.

Interest is guaranteed on the accumulated contract value at a rate specified in the contract. Additional interest amounts are guaranteed in advance on a yearly or other periodic basis. Those additional interest guarantees are possible due to the generally higher yields currently available in the money markets, efficiencies in the conduct of the life insurance business, and a willingness on the part of those insurers to accrue to their contractholders a greater portion of the interest earnings on their premiums.[1/] Presently Anchor's periodic guaranteed interest rates range from 8.25% to 9.25%.

Periodic income is guaranteed for the life of the annuitant commencing on the retirement date (usually age 65 or 70). The insurer assumes the risk that the annuitant may outlive his or her life expectancy. The insurer is thus obligated to provide the guaranteed income in a periodic amount fixed at retirement for however long the annuitant lives. Often the policy permits the holder to specify a period certain, during which the Company will guarantee to pay benefits for a fixed number of years, in addition to the life annuity. In this way the purchaser can protect against the early death of the annuitant by the selection of a beneficiary to receive the balance of the period certain payments.

Under present law, premiums on nonqualified deferred annuities are paid with after-tax income. That is, unlike IRAs, no deduction of the purchase price is allowed to the individual. The interest portion of the annuity value is taxed as payments are made to the annuitant. Thus, taxation of the internal build-up is merely deferred, not eliminated: when the accumulated value is paid out in the form of annuity payments, the recipient is subject to tax on the deferred income. Death

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[1/] The insurance industry generally has been criticized in recent years for its low rates of return on the cash value of life insurance policies. Staff Report to the Federal Trade Commissioner. Life Insurance Cost Disclosure (July, 1979).

benefits payable by reason of the death of the annuitant during the deferral period are taxable to the extent of deferred income. In short, in no instance does any income from a deferred annuity contract escape taxation.

Changes made by Congress in 1982 and 1984 refine the taxation of annuities, with a view toward ensuring that the deferred annuity will be used only as a long-term retirement income vehicle. In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress sought to "level the playing field" to ensure that deferred annuities were not used as short-term vehicles in substitution for bank deposits and CDs. TEFRA reversed the ordering rules relating to partial contract surrenders, requiring that income withdrawn be treated first as taxable income to the extent of such income in the contract. Loans were effectively eliminated by treating them as taxable withdrawals. Additionally, a penalty tax of 5% was assessed against taxable interest income withdrawn or borrowed prior to age 59-1/2 or 10 years from the date of the contract, whichever occurred earlier.

The Tax Reform Act of 1984 further restricted the owner's ability to borrow against or surrender the contract by imposing a penalty tax on such activity at any time prior to age 59-1/2 regardless of how long the premiums were invested in the contract. Additionally, new definitional language requires a distribution of contract values within a specified period upon the transfer of the contract by reason of the death of the owner. The Technical Corrections Act to the 1984 Tax Reform Act, now pending as H.R. 1800, would expand these forced distribution rules to include transfers by gift as well as by reason of death.

It is submitted that the re-examination of the annuity issues within the broader context of the 1985 tax reform proposals is untimely and seeks to correct alleged abuses in a product that has been examined in great depth by Congress no less than three times in the last eight years and twice in the last three years. In these past considerations, Congress has examined arguments that tax deferred annuities are tax shelters, that they unduly benefit the rich, and that they create an "uneven playing field," unfair to other financial institutions. In 1978, the concept of tax deferral of internal build-up was found to have merit and the "tax shelter" and "benefit the rich theories" were rejected. In 1982, legislation eliminated unduly favorable elements of the program and "leveled the playing field" with changes that made the use of the deferred annuity as a possible replacement for CDs and other short-term instruments undesirable. Indeed, the Joint Committee concluded its discussion of the changes enacted by TEFRA with the statement that "the use of deferred annuity contracts to meet long-term investment and retirement goals [is] still a worthy ideal." Joint Committee of Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, 361 (1982).

In addition to further restricting the use of annuities as short-term investment vehicles, the 1984 Act specifically requires the Treasury (in consultation with the Joint Committee on Taxation, the Ways and Means Committee and the Senate Finance Committee) to conduct "a full and complete study" of the taxation of life insurance. Section 231 of the Act provides that the study "shall also include an analysis of life insurance products and the taxation thereof." Treasury is to submit interim reports to the Ways and Means Committee and the Senate Finance Committee on July 1, 1986, 1987 and 1988. A final report is to be submitted on January 1, 1989.

Congress mandated these studies to determine whether the 1984 Act changes to annuity taxation were effective and appropriate in light of subsequent industry experience. Yet the ink was scarcely dry on the 1984 Act -- with even the first of the interim reports almost two years away -- when the Treasury, in November 1984, proposed to change the taxation of annuity contracts once again. Viewed against this legislative background, reconsideration of the annuity issues at this time is simply premature.

A brief analysis of the Administration proposals to tax internal build-up in deferred annuities and life insurance reveals their devastating effect on the contractholder, on the life insurance industry and on the thousands of small businessmen and women who make up the professional insurance sales force in the United States. The loss of tax-deferred internal build-up would require that the industry find a public acceptance for cash value policies that in the deferral period produce taxable income without any corresponding cash that can be used to pay taxes. The willingness of the public to accept and to purchase a vehicle generating current taxable income without corresponding cash flows is untested and highly questionable.

Alternatively, the industry will be confined to the sale of term insurance and cash value qualified plan products. As one of the leading companies in the movement to provide greater rates of return to the consuming public, it is Anchor National's experience that a viable agency force cannot be maintained on commissions generated solely from the qualified plan and term insurance markets. Thus, the predictable result of the Proposal is a massive contraction in the size of the industry and a reconcentration on qualified plan and term insurance markets.

Tax reform in itself is a laudable goal. Abuses and special preferences could be eliminated in the pursuit of such reform, however, without the wholesale destruction of any industry.

Appendix C to the Administration proposal projects income to the Government from the repeal of deferral of inside build-up on annuities at approximately $1 billion over five years through fiscal year 1990. While this amount appears de minimis in connection with a $600 billion proposal, we do not believe that this amount or any significant amount of revenue at all will be collected if the proposals are adopted. The more likely scenario is that the elimination of tax deferral of internal build-up will result in the elimination of the product line entirely, producing no net tax effect.

One argument advanced by the Administration is that the tax deferral of annuities favors wealthy individuals. Contrary to this assertion, however, the experience of Anchor National demonstrates that the primary appeal of the deferred annuity is to the middle class. This is demonstrated by the company's average current policy cash value as of July 1, 1985, of approximately $11,500 (considered on the basis of accumulated premiums plus interest), and the average cumulative premium received per policy of approximately $8100. Further, the average age of purchasers of 51.7 years (determined in a special study of annuity production during June of 1985) demonstrates that the funds are being invested for retirement purposes and remain in the policy until the retirement years. The 1982 and 1984 Tax Act changes effectively have eliminated the use of annuities by younger individuals as short-term investment vehicles.

The middle class marketing orientation is evident in the current range of minimum annual premiums which will be accepted by the company for an annuity. That range is between $240 (payable at $20 per month) and $1500. Thus, a purchaser of relatively modest means is able to afford an annuity. It is precisely this group that should be encouraged to plan for long-term retirement savings, and it is this group that, if forced by the adoption of the Administration's proposals to pay a tax on funds that will not be withdrawn for many years, would be most inclined to stop purchasing annuity contracts. The wealthy, who are capable of affording greater risks, can achieve much better rates of return and tax benefits through more elaborate means, such as the purchase of municipal bonds or tax shelter programs. The reform proposals cannot be said to promote fairness when they will result in the elimination of a valuable savings vehicle of particular use to those of limited financial opportunities.

Further, the life insurance industry has uniquely provided a massive source of capital for growth in this country. In 1983, for example, net investments in U.S. capital markets by life insurance companies totaled $56.6 billion, placing life insurance companies third among all private domestic institutions as a source of funds. Taxation of the internal interest build-up on annuity contracts and life insurance would significantly curtail the availability of such funds for long-term investment and therefore would impede capital formation.

The life insurance industry in the past has been an especially efficient collector of small amounts of premiums. Its performance of this role has enabled the average working class American over the years to create an estate by the concentration of those premiums and cash values into retirement and death benefits. The loss of the tax deferral of the cash value of annuity and life insurance products will mean the destruction, both on an individual basis and on a macroeconomic basis, of an important engine for economic growth in America.

Finally, the proposal to eliminate tax deferral of internal build-up violates the fundamental principle of the Internal Revenue Code that income is recognized and therefore taxable only at the time of its receipt or accrual to the taxpayer. The Administration proposals would be inconsistent with the doctrine of constructive receipt, which is inapplicable where a taxpayer can receive funds only by giving up valuable rights. In essence, the proposal would require the taxation of the unrealized appreciation in annuity and life insurance contracts. This result is the same as taxing the appreciation in the value of a home, even though the owner will not receive the proceeds of such appreciation until the house is sold.

The Administration proposal indicates that the reason for the elimination of the tax deferral of internal build-up is that such deferral results in a major distortion of savings flows from other financial institutions to the life insurance industry. This allegation is not supported by any significant studies of which the Company is aware. Further Congress examined and rejected this argument in the proceedings on the Revenue Act of 1978.

Perhaps most important, the "level playing field" argument is an attempt to compare apples and oranges. Bank deposits and certificates of deposit are essentially different than deferred annuities, both in nature and ultimate purpose. Bank deposits and certificates of deposit provide short-term liquidity and a degree of flexibility not present in annuities. A deferred annuity represents a long-term vehicle for the accumulation and payment of retirement income.

Even if one were to accept that banks and insurance companies are in direct competition for the same type of consumer savings, a proposition with which the Company disagrees, it does not follow that the elimination of tax deferral of the internal build-up on annuities is either desirable as an end in itself, or would create the desired "level playing field". The regulatory climate outside the tax law is much more favorable to banks and other savings institutions. For instance, banks are exempt from SEC regulation on certificates of deposit and other evidences of indebtedness that if issued by an insurance company would require registration of both the salesperson and the product itself. Federal deposit insurance for banks and savings and loans has no real counterpart in the life insurance area. Further, seventy percent of the average dollar expended by the insurance industry in the annuity line of business goes to reserves. American Council of Life Insurance, 1984 Life Insurance Fact Book 62 (1984). In contrast, banks must hold in reserve a maximum of only about twelve percent of their transaction accounts (checking accounts, demand deposits), and some small banks may set aside a little as three percent. 12 C.F.R. 204.9(a)(1) (1985). Moreover, banks need not set aside any reserves on late-muturing institutional time deposits (long-term CDs sold to institutions rather than individuals). Id. In view of these differences, the passage of these proposals would not promote a level playing field; to the contrary, it would leave the insurance industry structurally uncompetitive.

In conclusion we believe that the deferred annuity policy, with deferral of taxation on the interest accumulation until such time as benefit payments result, is a valid and necessary component of the larger national retirement income policy. It is demonstrable that this product is purchased largely by persons of middle income and modest means, generally at later ages, for the primary purpose of providing an additional income source during requirement. The social and economic benefits supporting the present tax policy are increasingly compelling due to the need to provide supplemental benefits in addition to the basic minimum benefits provided by social security. The proposals if adopted will not demonstrably add even the de minimis amounts assigned to it as future tax revenues and is likely to result in greater expense to the government than revenues gained due to the anticipated economic dislocations. In short, the elimination of the tax deferred internal build-up on deferred annuities does not fulfill any of the tax reform objectives of fairness, simplicity or the promotion of economic growth.

Statement by

THE CHUBB CORPORATION
and
THE CONTINENTAL CORPORATION

Before the
COMMITTEE ON FINANCE
of the
UNITED STATES SENATE

Concerning

FEDERAL INCOME TAXATION OF PROPERTY-CASUALTY INSURANCE COMPANIES

October 1, 1985

Mr. Chairman, other distinguished Committee members, my name is John P. Mascotte, and I am Chairman and Chief Executive of The Continental Corporation. Seated next to me is Dean O'Hare, Executive Vice President of The Chubb Corporation. This statement is made jointly on behalf of both companies--we are two of the largest independent underwriters of property-casualty (p-c) insurance in the United States.

The various trade associations have already testified to the appropriateness of the regulatory accounting rules that for so many years have provided the basis for the present method of income taxation. We firmly support the positions set forth by them.

Without any intent to contradict or detract from these positions, I would like to bring to your attention certain provisions of the Internal Revenue Code that permit the tax accounting system of a p-c company to be used to shelter the income of other companies--the consolidated return provisions of the Code.

The p-c business is a cyclical business. In the downturn of the cycle, a p-c company generates large tax losses under its tax accounting rules which are generally the same as the state regulatory accounting rules. Under state regulatory accounting a p-c company spreads its premium income over the term of the insurance policy and deducts immediately acquisition expenses incurred; in addition, a p-c company deducts currently its estimate of losses incurred and its estimate of settlement expenses.

The accounting rules for p-c companies have as their underlying purpose the preservation of company solvency to protect the interest of the policyholder. These accounting rules cannot be availed of directly by any other type of business; only a company chartered under State law to conduct a p-c business can use this accounting system. Moreover, Treasury's revenue is protected as long as other companies cannot avail themselves of the p-c statutory accounting rules to utilize otherwise unutilized tax losses.

The delicate balance between protecting policyholders and the Treasury's revenue is destroyed when others can avail themselves of the tax accounting rules applicable to p-c companies. This can occur when a non p-c company files consolidated returns with a p-c company to utilize its tax losses. When consolidated returns are filed, the p-c tax accounting system is utilized by the non p-c company even though the non p-c company could not directly conduct the p-c business. This is a unique phenomenon under the tax law in that most other tax accounting rules available through consolidation can be availed of directly by all types of taxpayers. Examples include depreciation, depletion, research and development expenses, etc.

The magnitude of the p-c tax losses used by non p-c companies through consolidation can be gleaned from the fact that over one half of the twenty-five largest p-c companies are owned by non p-c companies, and from the fact that for the year 1984 the United States p-c industry suffered gross underwriting losses of $21.3 billion which, after reduction by investment income totaling $17.5 billion, translated into a real economic loss for the industry of $3.8 billion. Although the actual tax benefits obtained from p-c/non p-c consolidation cannot be exactly determined from the public record, Continental, from a review of annual reports and annual statements of 10 large conglomerates with p-c affiliates, estimates that the loss to the Treasury with respect to these 10 companies alone may have been as high as $1 billion in 1984.

Before enacting any new tax on p-c insurers, we urge you to create a level playing field by repealing the existing Code provisions permitting p-c insurers to be included on a consolidated return with non p-c companies.

I shall be happy to answer any questions.

Thank you.

October 15, 1985

STATEMENT OF THE MUTUAL LIFE INSURANCE COMPANY COMMITTEE

This statement is submitted on behalf of the Mutual Life Insurance Company Committee, a group of 40 mutual life insurance companies interested in the development and implementation of the life insurance tax provisions adopted in the Deficit Reduction Act of 1984 ("DEFRA"). The Mutual Life Insurance Company Committee fully supports the statement and testimony of the American Council of Life Insurance with respect to the life insurance tax legislation now under consideration by this Committee. This brief statement is directed to two of the Administration's proposals which, if enacted into law, would have a singular impact on mutual life insurance companies.

The first of these is the proposal to permit ordinary corporations to deduct 10% of their dividends to stockholders. As this Committee is aware, under the life insurance tax provisions contained in DEFRA, mutual companies are subject to a special "add-on" provision that does not apply to any other corporation. The theory underlying the "add-on" is that a portion of the dividends paid to mutual company policyholders is similar to the nondeductible dividends paid to stockholders of ordinary corporations, and that the "add-on" is needed to offset the tax advantage that mutual companies would otherwise enjoy if they could deduct their dividends in full. While mutual companies do not agree with this theory, they accepted the "add-on" as part of the overall compromise that led to the enactment of the life insurance tax provisions of DEFRA. However, since the fundamental premise of the "add-on" is that the dividends of ordinary corporations are not deductible, adoption of the pending proposal to permit deduction of 10% of corporate dividends would require a corresponding adjustment in the "add-on." If the 10% dividend deduction proposal were adopted, we would be happy to work with the Committee in developing the statutory language needed to effectuate this adjustment.

The second of the proposals of special concern to mutual life insurance companies is the proposal to permit life insurance companies to hold only cash value reserves. With regard to this proposal, we wish to reemphasize at the outset our support for the position of the American Council of Life Insurance in opposition to any change in the reserve rules so recently adopted as part of DEFRA. Mutual companies, in particular, are opposed to any such change since new reserve rules would have a double adverse impact on mutual companies. First, the new rules, by reducing reserves, would increase the taxable income of mutual life insurance companies (as well as the taxable income of other life insurance companies). Second, because of the way the "add-on" is calculated, the taxable income of mutual life insurance companies -- and only mutuals -- would be further increased as a result of the reduction in reserves. One of the components taken into account in computing the "add-on" is the equity of a mutual company. If reserves are reduced as has been proposed, this will, in turn, increase mutual company equity and thereby increase the "add-on." In short, whereas stock companies would be impacted only once by the new reserve proposal, mutual companies would be impacted twice. We strongly urge that the new reserve proposal not be adopted, but if it were, we ask that this unfairness be corrected.

We wish to express our appreciation to the Committee for considering our views on these two points which have unique implications for mutual life insurance companies.

STATEMENT OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Before the Senate Finance Committee
In Regard To
The President's Tax Reform Proposal

October 1, 1985

Mr. Chairman:

Thank you for the opportunity to meet with this committee to express the collective concerns of the National Association of Insurance Commissioners (NAIC) regarding the President's tax reform proposal in so far as it relates to the accounting for reserves for policyholder benefits, claims and losses for both life insurers and property and casualty insurers.

The business of insurance is regulated exclusively at the state level. State insurance departments (which are members of the National Association of Insurance Commissioners) are responsible for supervising and maintaining the financial solvency and the stability of insurance companies and protecting the interests of the insuring public.

The Administration in its May, 1985, recommendations to Congress for Federal tax reform, has proposed changes to the Internal Revenue Code which would dramatically alter the way insurers are taxed. The NAIC is greatly concerned with the anticipated effect of the following two tax proposals:

- The proposal to limit life insurance company reserves to amounts equalling the cash surrender values of life insurance policies, and

- The proposal to impose a Qualified Reserve Account (QRA) tax method on insurers selling property and casualty, health insurance, and other non-life insurance products.

The NAIC appreciates the desire of Congress to raise additional revenues. However, we oppose any method of taxing insurers that would weaken or radically change the tax law's recognition of traditional methods of reserving for policyholder benefits. Current state regulatory requirements for policyholder reserves are designed to preserve the safety and soundness of the insurance industry and, more importantly, to protect the ultimate beneficiaries, the insuring public.

After more than two years of study, the Treasury and Congress agreed to the 1984 Life Insurance Company Tax Act provisions which, in principle, affirmed the role of state regulatory authorities in safeguarding insurance company solvency by prescribing life insurance company tax reserves to be not less than those prescribed by the minimum standards of a majority of the states. This change did abandon net level reserving in favor of the less conservative, although acceptable, CRVM method, which now requires the least conservative mortality, morbidity and interest assumptions.

The current proposal to limit life insurers' reserves to cash surrender value equivalents is even less conservative and, as such, is a disincentive for maintaining adequate reserves. The tax proposal erroneously assumes that a life insurance product cannot have a savings component in its actuarially determined gross premium that is not, in essence, a cash surrender value that is payable on demand. Many life insurance products that have an offer value to the insuring public, such as single premium group deferred annuities, level premium term policies (of 5, 10 and 15 years), waiver of premium and accidental death and dismemberment coverages do not have cash surrender values but, nevertheless, would be actuarially unsound without some pre-funded savings component inherent in the gross premium. Further, this tax proposal in its current form may create unreasonable disincentives to offering any life products other than one year renewable term insurance coverages or those with contractually stated cash values that are substantially equivalent to the CRVM reserve.

In regard to the taxation of property and casualty companies, a stated objective of the QRA method is to achieve parity of tax treatment between self insurance and traditional insurance. The tax proposal seemingly ignores the social value of traditional insurance. The purpose of traditional insurance is to transfer risk to the third party insurer. This underwriting mechanism affords the spread of risk, guarantees benefits and claims, maintains assets to fund policyholder obligations, and is subject to stringent state regulation. Self insurance is a misnomer as it is actually non-insurance which affords none of the attributes of an indemnification insurance contract. Thus, the comparison of traditional insurance to non-insurance concepts is an inappropriate analogy (unless it becomes public policy to severely limit the business activities of the insurance industry as we know it).

The QRA method requires insurers to anticipate actual future investment income related to policyholder reserves and, to the extent miscalculation of such income occurs, either intentionally or unintentionally, the QRA method will recapture in taxable income any actual difference. The effect of the QRA approach is to tax a portion of the accumulated reserves that are necessary to meet contractual obligations to policyholders. The QRA method is a subtle device to tax policyholder reserves for amounts that have not and will not inure to the insurer.

The QRA method will significantly diminish insurer capital and surplus (net worth) to the extent of the taxes related to anticipated, unrealized investment income. For insurers to offset the application of the QRA method, insurers will have to increase the cost of insurance to the public.

Because the QRA approach will effectively tax future investment income on an actual after tax yield basis, the investment function of the insurance industry will be critically affected. The actual after tax yield effect of the QRA method penalizes those insurers who have the more efficient investment operations. This kind of disincentive does not serve the public interest as it negatively affects the influence of investment income in the rate making process in open rating states and, thus, the competitive pricing of insurance products for the insuring public.

The QRA method fails to recognize that reserves for unpaid losses of policyholders are for claims already occurred (both reported and unreported) and are in effect demand liabilities. These unpaid loss liabilities are not akin to the future benefit reserves of life insurance companies that are set aside at appropriate discounted values to pay benefits and claims that will occur in the future.

The QRA will further promote novel self-insurance arrangements and foreign-based insurance arrangements designed solely to circumvent Federal taxes and state regulation. It will not serve the public interest if policyholder reserves and related asset funds are transferred to locations outside the supervision or control of state regulation.

The statutory accounting for reserves, as currently sanctioned by the Treasury, has worked well for over sixty years achieving its ultimate goal of assuring that the insurance industry can perform its promises and obligations to the insuring public.

Under the state statutory scheme of accounting, as well as generally accepted accounting principles, the current methods of reserving and premium recognition are appropriately matched. It is not the current reserving practices of the insurance industry that results in the reduction of insurer taxable income, but other taxation alternatives such as tax exempt income. The QRA approach is not an appropriate measure of true economic income.

To the extent any change in the system of taxing insurers is deemed necessary, the NAIC strongly urges Congress to pursue alternative methods of taxation which are consistent with the President's stated tax reform goal of simplicity and fairness. It is the collective desire of the state insurance departments that any method of taxation should contain incentives for adequate and sound loss reserving that will operate in harmony with state statutory accounting rules which are designed to preserve the safety and soundness of insurers.

Attached to our written testimony is a copy of a resolution on this subject adopted at the June NAIC meeting. Thank you for the opportunity to testify.

RESOLUTION
of the
NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS
June 14, 1985

WHEREAS, the Members of the National Association of Insurance Commissioners (NAIC) are responsible for supervising and maintaining the financial solvency of companies engaged in the business of insurance in the United States; and

WHEREAS, the United States Treasury has proposed changes to the Internal Revenue Code which would alter the way insurers are taxed; and

WHEREAS, after more than two years of study the Treasury and Congress agreed to the 1984 Life Insurance Company Tax Act provisions which affirmed the role of state regulatory authorities in safeguarding insurance company solvency by prescribing life insurance company tax reserves to be not less than those prescribed by the minimum standards of a majority of the states; and

WHEREAS, the proposal to limit life insurance company reserves to amounts solely equalling cash values is a disincentive for maintaining adequate reserves for future obligations under life insurance contracts; and

WHEREAS, proposals to tax insurers selling property and casualty, health insurance, and other non-life insurance products include a qualified reserve account method which fails to recognize minimum statutory reserves required by an established for those products; and

WHEREAS, the proposed changes in the Internal Revenue Code would act as strong disincentives for insurers to adequately reserve for losses.

NOW BE IT THEREFORE RESOLVED that:

1. The National Association of Insurance Commissioners opposes any method of taxing insurers, such as the qualified reserve account method, which would weaken the tax laws' recognition of state statutory accounting roles and their traditional methods of reserving for policyholder benefits, claims and losses; and

2. To the extent any change in the system of taxing insurers is deemed necessary, the NAIC strongly urges Congress to pursue alternative methods of taxation which are consistent with the President's proposal for tax reform - simplicity and fairness, which contain incentives for adequate and sound loss reserving, and which operate in harmony with state statutory accounting rules designed to preserve the safety and soundness of insurers.

Statement by
The National Association of
PROFESSIONAL INSURANCE AGENTS

concerning

THE IMPACT OF TAX REFORM
ON THE INSURANCE INDUSTRY

Submitted to the

COMMITTEE ON FINANCE

UNITED STATES SENATE

October 1, 1985

The National Association of Professional Insurance Agents (PIA) is a national trade association representing more than 40,000 independent property and casualty insurance agents in all 50 States, the District of Columbia, Puerto Rico and the U.S. Virgin Islands.

PIA has closely followed the evolution of the tax reform proposal that is now before the Finance Committee. The provisions amending the tax treatment of property and casualty (P&C) insurance companies and employee benefits are of special interest.

We welcome this opportunity to express PIA's opposition to the insurance provisions contained in President Reagan's plan for a comprehensive revision of the Internal Revenue Code of 1954, as amended. Since this hearing will consider the impact of tax reform on the insurance industry, PIA's comments will be limited to the plan's tax treatment of P&C companies and how this would impact adversely on insurers, insurance agents and ultimately the insurance consuming public.

The controversy surrounding the tax treatment of P&C insurers centers around the following proposed changes:

1. The establishment of discounted loss reserves using the "qualified reserve account" (QRA) approach. This method would cover both stock and mutual P&C insurance companies.
2. The changes in tax benefits for mutual P&C companies.

(a) The repeal of the protection against loss (PAL) account.

(b) The repeal of tax provisions aiding small mutual insurers.

(c) The limiting of insurer deductions for dividends paid to policyholders.

PIA believes that the amendments outlined above should be rejected by the Committee.

Under current law, the taxable income of P&C insurers is taxed at the same rates that generally apply to other for-profit corporations. The computations used to determine taxable income for P&C insurers are obtained from the statutory annual statement that an insurance company must prepare and file to comply with the regulatory requirements of state insurance departments. This statement is based on the statutory accounting system developed by the National Association of Insurance Commissioners. Under statutory accounting, there is no discounting of reserves and acquistion costs are expensed immediately. The use of this accounting system, that is unique to the insurance industry, is mandated by state insurance regulations to help ensure that insurers will have adequate reserves available to finance loss payments on all claims that become due. Statutory accounting is an integral part of the regulatory programs that are designed to protect the public as consumers of insurance products. The current federal tax treatment of P&C insurers recognizes and reflects the statutory accounting rules that are essential to the financial soundness and stability of our industry and that have been the accounting basis for determining an insurance company's taxable income since 1921.

The Administration wants to change the current methodology for determining insurer taxable income because their entire reform package is based on the premise that there will be an expanded tax base. Obtaining that broader base has become a priority goal for the Administration. Their other priority goal is aggregate tax revenue neutrality. This apparently will be achieved by raising the real tax burden imposed on domestic corporations to offset the revenue loss from rate reductions proposed for individual taxpayers.

THE QUALIFIED RESERVE ACCOUNT

The QRA method of discounting loss reserves is the most harmful provision in the Administration's P&C tax package.

Under current tax treatment, P&C insurers can deduct, as present expenses, the funds they reserve for payments of losses in the future. P&C loss reserves are for insurable losses that have already occurred and they are totally expensed. Insurer acquisition costs are also expensed immediately.

QRA would change the current tax approach by requiring that only a discounted value of the reserve amount could be expensed. Discounting is based on the concept of a time lag (what the Administration refers to as "the time value of money") that exists between the occurrence of an insurable event and the date of payment. Under QRA, only an amount currently reserved which would grow by investment income to the amount needed in the future to fund the loss payment could be expensed for current tax purposes.

It is discounted by an investment income rate.

According to the company side of the P&C insurance industry, QRA poses a number of serious problems. It may impose a tax where there is no economic gain. It could push certain P&C companies experiencing temporary market difficulties into insolvency if the new tax burden caused them to lower reserves. It would reduce the reserve safety factor built into statutory accounting and be an incentive for companies to under-reserve. It may require state insurance regulators to require higher reserves to compensate for the capital reductions experienced by insurers hit with the increased federal taxes that QRA would impose.

Administratively, QRA would create substantial new bookkeeping burdens on P&C insurers. Joseph M. Jordan, a tax expert at Peat, Marwick & Mitchell, reports that a separate set of books would be required for each line of insurance that a company writes. Insurers may be required to keep three sets of books: a statutory accounting set for state insurance regulators, a general accounting standards set for stock companies reporting to the Securities and Exchange Commission, and a set(s) for the Internal Revenue Service for federal tax purposes. PIA would like to suggest that all of the additional accounting and bookkeeping needed to comply with QRA somehow does not seem to logically fit into a tax reform scheme that is being sold to the public as one of simplification and fairness.

QRA would have a significant impact on the cost of insurance premiums. A recent analysis by the A.M. Best Company, a recognized insurance research organization, indicates that QRA would cause premiums for P&C coverages to increase by an average of 11%. Certain lines of insurance would be much higher: 32% for medical malpractice, 15% for workers' compensation, and 24% for general liability. These QRA induced increases would be added on top of major premium increases already taking place in a hardening insurance marketplace. The costs of QRA will become an added cost of doing business and will inevitably be passed on to the insurance consumer as higher premiums. PIA believes that this price inflation would not be beneficial to the insurance consumer.

QRA is opposed by the entire P&C insurance industry. Companies and producers, representing both the stock and mutual sides of the business are united in their opposition to this ill-advised proposal. The trade associations representing the P&C insurers that will appear before the Committee today have analyzed the serious shortcomings of the QRA proposal in detail. PIA strongly urges the Committee to carefully consider the objections that they have raised.

PIA believes the QRA is a very bad idea that is being proposed at the worst possible time in the current underwriting cycle. P&C companies are now in the process of recovering from large underwriting losses experienced in recent years. This soft market situation is beginning to turn around and harden. At this stage of the underwriting cycle, a major new tax increase would be a significant and unwarranted new burden on the industry's financial position and impair its financial stability.

It is indeed unfortunate that the Administration appears to be unmoved by the petitions and analysis of the insurance industry regarding QRA and continues to press for the taxation of investment income generated by loss reserves. PIA trusts that the Finance Committee will consider this issue with a more open and objective frame of mind.

MUTUAL INSURANCE PROVISIONS

Mutual P&C insurance companies are owned by the policyholders they insure. Under current law, mutual P&C insurers benefit from certain tax provisions that recognize the special nature of the mutual organization. The Administration wants to change this situation in a manner that would have a serious impact on mutual P&C insurers. They propose a repeal of the PAL account provision which applies only to mutual P&C companies. PAL allows mutual insurers to defer a portion of their taxable income for up to five years as a cushion against future years when major or extraordinary losses may be incurred. PAL provides capital for mutual company underwriting needs throughout the underwriting cycle. It provides them with the ability to increase their capital to meet unexpected losses. Unlike stock insurance companies, mutuals do not have access to capital markets to raise funds. As a practical matter, mutuals can generate capital only through retained earnings.

Without PAL, a mutual can raise capital only by selling additional policies or inducing existing policyholders to contribute needed capital. Under current market conditions, neither of these approaches are practical in terms of covering a major loss situation.

PAL is therefore essential to the economic wellbeing of mutual P&C insurers throughout the underwriting cycle and has been part of the Internal Revenue Code since 1962. Mutual companies continue to have special need in raising capital to handle extraordinary losses. There is nothing to suggest that those needs have changed. PIA believes that the current PAL provision should be retained.

The Administration would also repeal certain tax advantages designed to help small mutual insurers. A recent survey conducted by the National Association of Mutual Insurance Companies shows that the repeal of these small company provisions would amount to a tax increase of 140%. This, when added to the increased tax burden of QRA, may well force a number of small mutual P&C insurers out of business. PIA urges the Committee to retain these small mutual company tax benefits.

Last, but not least, the Administration's tax package proposes to limit the deductions of mutual insurers for policyholder dividends. Under current tax treatment, such "dividends" are a proper deduction because they are, in fact, a return to the policyholder of excess premiums that are not needed to finance the insurer's insurance fuctions. The Administration's approach would amount to a new tax on equity because policyholder dividends flow to the mutual policyholder both as an owner of the company and as a policyholder. PIA believes that the deductions in current law for policyholder dividends provide a consumer benefit and should be retained.

When the Administration's tax proposals pertaining to mutual companies are added on top of a mutual's QRA tax burden, it amounts to a heavy new tax increase on the mutual side of the P&C industry. Now this approach may purport to broaden the tax base, but will it really? If a number of mutuals are forced out of the business by this tax package, that would certainly not expand anybody's tax base. Mutuals may not be able to pass these tax increases along to their policyholders as premium increases. The insurance consumers tolerance of price increases in many lines of coverage does indeed have certain limits.

The Administration's new tax plan for the P&C industry does not serve the public interest. It proposes a basic fundamental change in the longstanding public policy of supporting insurance in the Internal Revenue Code as a means of providing needed protection to the public. The essential public protections provided by the insurance industry would be reduced to achieve revenue enhancement should the provision discussed in this statement become law. PIA urges the Committee to prevent this from happening.

This tax plan could not be proposed at a worse possible time in terms of its potential adverse impact on the property and casualty industry. 1984 was one of the most difficult years that the industry has ever experienced. The underwriting cycle and soft market had bottomed out. Many insurers had their worst business year ever and many are still having financial difficulties. State insurance regulators are expressing serious concerns about their solvency. Early this year, the business started to slowly recover as the soft market reached its ebb and insurers began increasing premiums on almost all lines of insurance. The return to underwriting profitability appears to be getting underway but this is always a rocky road and there is still a long way to go.

Now comes the Administration seeking to impose major new tax increases on top of the already difficult financial condition P&C insurers are still experiencing. If these tax changes become law, this situation will only be exacerbated. Premium rates would have to be increased to finance the new tax burden over and above the major rate increases that are already taking place as the market and underwriting cycle continues to harden.

The QRA method of discounting loss reserves would cause large price increases in long-tail liability lines of insurance such as medical malpractice, workers' compensation, latent occupational diseases, traumatic injuries, and environmental pollution. This is a segment of our market that is already in serious trouble in terms of price, capacity and availability. QRA would only make things much worse.

Pricing problems will not be the only result of the P&C tax package should it become law. A serious capacity problem would also occur. Capacity is the total amount of a line(s) of insurance that a company can safely underwrite. Capacity is based on an insurer's reserves. With QRA changing the way reserves are calculated, the industry believes that capacity will decline with resulting reductions in capital. Prudent insurers seeing their capital decline will reduce the writing of certain lines of insurance. If a company cannot reserve at a level they are comfortable with, a decision may be made to withdraw completely from selected lines. The lines that will be the first to go in a tax induced capacity crunch should be the long-tail lines previously discussed. Certain high risk long-tail coverages may become unavailable at any price. These are lines that insure against risks for which the public, and in some instances the law, expects coverage to be available. It is important to stress that it is QRA that will reduce insurer capacity and this would occur no matter what conditions happened to exist in the insurance marketplace.

The serious problem that the Administration's tax package would impose on the domestic insurance industry and the political process thereinvolved are being carefully monitored by foreign insurers that are always exploring new opportunities to write business in the United States. The tax plan's resulting substantial cost increases and availability problems will put domestic insurers in a precarious competitive position, by giving their offshore competition a major price advantage because offshore insurers can circumvent both federal taxes, and state regulatory and statutory accounting requirements. The business placed with foreign insurers will be harmful to the stability of the domestic insurance industry and further aggrevate our balance of payments deficit.

Independent insurance agents are compensated by receiving a percentage of the premium dollar they produce. Anything that causes reduced insurer capacity and an availability problem for certain lines of coverage, directly and adversely impacts upon our ability to serve our clients and earn a living. The reduced insurance capacity that should result from the Administration's tax package will mean that less insurance coverage will be available for the consuming public and the agent's book of business will decline. As you can see, PIA's membership has very valid reasons for opposing the proposed P&C tax plan.

It is important to note that independent agents are already listening to vocal complaints from their clients who object to rising premium rates and protest availability problems caused by the hardening insurance market. PIA can assure you that if the proposed new P&C tax burden causes additional significant premium increases and capacity problems, those complaints will become howls of outrage. We must never forget that these citizens will also want to know what is responsible for the price and availability problems that they are experiencing and their agents have an obligation to inform them.

PIA urges the Members of the Finance Committee to look very carefully at all of the tax changes the Administration is advocating. We strongly urge you to preserve the provisions in the current tax code that are beneficial to the insurance industry and that support its fiduciary responsibility to provide essential economic security and socially accepted benefits to the public.

# # # #

STATEMENT OF THE NEW YORK LIFE INSURANCE COMPANY

ON

TAXATION OF THE INSURANCE INDUSTRY

SUBMITTED

IN CONNECTION WITH

HEARINGS BEFORE

THE U.S. SENATE

COMMITTEE ON FINANCE

ON OCTOBER 1, 1985

The New York Life Insurance Company appreciates this opportunity to submit a written statement in connection with the hearings being conducted by the Senate Finance Committee on the insurance-related aspects of tax reform.

New York Life is a mutual life insurance company, incorporated in 1845 and domiciled in New York State. We employ approximately 10,000 individuals, about half of whom work in our Home Office in New York City. In addition, we have about 10,000 full-time life insurance agents. At this time, New York Life and its subsidiaries have over $30 billion in total assets, $200 billion of insurance in force and over six million policyowners.

New York Life supports the principles of developing a fairer, more simplified, and more growth-oriented tax system. We must, however, register our serious concern with the proposals to alter the taxation of the life insurance industry, both policyowners and companies. We wholeheartedly support the statements opposing any of the proposed changes in life insurance, annuity and employee benefit taxation made by the life insurance company and agency trade associations which were delivered during the hearings held on October 1, 1985.

In this statement, we would like to do four things:

. First, explain the intents and purposes of permanent life insurance, deferred annuities, and employer-provided group term life, and show how they fulfill those purposes.

. Second, point out the misconceptions inherent in the Administration's May, 1985 tax proposal and the House Ways and Means Committee Staff Options, regarding the taxation of:

-- The cash value increase in permanent life insurance contracts and policy holder loans,

-- The increase in the cash value of deferred annuities, and

-- Employer-provided group term life insurance.

. Third, explain how existing laws -- specifically TEFRA (1982) and DEFRA (1984) -- recently reformed the tax treatment of insurance products, and should be given the opportunity to work.

. Fourth, point out the havoc these proposals could wreak, both socially and economically, should they become law.

The Purpose of Permanent Life Insurance

Permanent life insurance was developed to enable individuals to afford lifetime family protection: They don't have to give up protection in later years when the cost of term insurance becomes prohibitive. The concept which makes this possible is the level premium -- a sum which is greater than the risk calls for in the early years, but considerably less than the risk calls for in the later years.

Life insurance, along with home ownership and retirement savings, is one of the cornerstones of family protection. Contrary to some assertions, the vast majority of permanent insurance is bought by middle income taxpayers for death protection. It assures them that in the event of their death their children can still be educated, their homes will not be lost to their families, and the standard of living they have enabled for their loved ones won't be drastically reduced. For many, life insurance provides the difference between economic freedom and dependency on social welfare programs.

Permanent insurance is the only vehicle that assures the lifetime affordability of life insurance protection.

Deferred annuities are essentially vehicles for retirement planning. They were designed to provide a way of accumulating funds over a certain period, and then distributing those funds over an uncertain one: the lifetime of the annuitant. They are an almost ideal solution to the "problem" of living longer than one's ability or desire to earn wages. As such, they lighten the burden of the elderly on government resources.

Unlike qualified retirement plans, deferred annuities are purchased with after-tax dollars. There is no tax deduction to compensate for, as is the case with qualified retirement plans.

Employer-provided group term life insurance is an efficient and low cost form of family financial protection against premature death. Currently, 96 percent of all full-time employees of large and medium-sized firms are receiving this coverage. For many, it is the only life insurance they have -- either because they cannot afford individual coverage, or cannot qualify for it. The average face amount of group term life for all employees is only $26,000, a small, and in some cases desperately needed, sum in the event of a wage earners death.

None of these products should fall prey to the tax collector, except insofar as they are already taxed. The new taxes being proposed for them stem from some underlying misconceptions about the nature of the products or their intended purpose, by the insurer or purchaser.

Underlying Misconceptions

Permanent Life Insurance and Policy Holder Loans. Permanent life insurance is not an alternative short-term investment medium. It is financial protection against the risk of dying too soon. It involves long-term commitments on the part of both life insurance policyowners and life insurance companies and should not be treated or taxed like something it is not and never was intended to be.

Unlike short-term investments, the cash values of permanent life insurance cannot be obtained by policyowners without giving up important rights. Taxing the inside buildup of permanent life insurance would be like taxing the appreciation in one's home before it is sold.

A Legislative Attorney with the Congressional Research Service of the Library of Congress, Robert B. Burdette, makes a further point in a paper released on June 11, 1985, on the subject of the proposed tax on life insurance. He notes that the insured policyowner has only one of several interests in a life insurance policy, the beneficiary and the insurer having the other interests. Thus, it would be unfair to tax the policyowner currently when he or she may never realize any of the interest being taxed.

The shift of emphasis contained in the Ways and Means Staff Options is equally misguided. The staff proposal would foregoe the tax on the inside cash build-up of life insurance, but tax a policy loan as income, and eliminate the deductibility of the interest paid on it.

Basic tax rules governing loans provide that borrowing does not create increased ordinary income or gain on the disposition of a capital asset. Loans made against a life insurance policy represent indebtedness like any other kind of loans. They should receive the same tax treatment as loans made against the collateral of any other type of property.

If there is a philosophical intent by the Congress to preserve the tax-free status of the unrealized increase in cash value life insurance, then no tax restrictions should be imposed on borrowing against those cash values. To impose such a tax would merely transform the taxation of increased cash value from an annual event to one triggered by the use of the policy as collateral for a loan.

Applying uniform tax treatment to life insurance policy loans and loans on qualified retirement plans is improper, because contributions to qualified plans are tax deferred, unlike premiums for life insurance policies which are paid with after-tax dollars.

Deferred Annuities. Deferred annuities were never intended as vehicles for short-term savings or investment. They have never been marketed that way. Any possibility that they could be put to such a use was effectively dealt with by prior legislation.

The dollars paid into a deferred annuity are after-tax dollars taken from disposable income. To equate those dollars with the pre-tax dollars paid into a qualified plan and apply the same early withdrawal penalty, as the Ways and Means staff proposal has done, is simply unfair. The higher premature distributions penalty tax on qualified plans is, in part, designed to compensate Treasury for the revenue foregone in prior years as a consequence of the initial deduction. Obviously, no such compensation for lost revenues is required for nonqualified annuity contracts.

In addition, the Ways and Means proposal which requires taxpayers to include in current income the increase in an annuity contract's cash value above the aggregate premium investment of $100,000 would result in the inconsistent tax treatment of contract holders. The proposal would discriminate against older Americans who later in life seek to provide themselves with retirement income, because the maximum tax deferral benefit accrues to those who pay the greatest amount of premium into an annuity contract as early in life as possible. For example, a 30-year-old individual would reap seven times the retirement income for a $100,000 deposit than would a 50-year-old.

Employer-Provided Group Term Life. The rationale for repealing the $50,000 exclusion on employer-provided group term life is that it will achieve horizontal equity. The fact is, however, that with nearly universal coverage (96%) among full time workers in large and medium-sized firms, horizonal equity has already been established

Group term life is an equitable method of providing life insurance protection, and is already governed by nondiscrimination rules which prohibit preferential treatment for higher paid employees. Furthermore, group term life insurance is not abused or "overconsumed." With employer-provided group term insurance averaging $26,000 per employee, coverage is equivalent to less than two times the average worker's annual salary. Rather than a "windfall," this offers a modicum of financial assistance to the worker's spouse and children.

Recent Comprehensive Reform of Life Insurance Taxation

Taxation of the insurance industry has undergone extensive review and reform in the last four years. The taxation of life insurance policyowners and companies was addressed in both the Tax Equity and

Fiscal Responsibility Act of 1982 (TEFRA) and the Deficit Reduction Act of 1984 (DEFRA). The new proposals do not address new concerns; rather they reopen issues that were raised and dealt with in these two major pieces of legislation. Life insurance policyowners and companies need some tax certainty in their planning and operations, and the existing tax reforms need time to work.

TEFRA and DEFRA satisfactorily address the following issues:

. Life Insurance Policy Tax. By defining life insurance, in connection with flexible premium policies under TEFRA, and with all policies under DEFRA, Congress has already dealt effectively with the concern that some life insurance policies stressed investment rather than protection. As part of its testimony in developing DEFRA, the Administration indicated that if its definition of life insurance -- which precluded excessive investment in insurance contracts -- were adopted, yearly taxation of cash value increases would be unnecessary. DEFRA accomplished this by restricting the amount of premium that a policyowner can pay into a contract in relation to that contract's death benefit.

. Taxation of Policy Holder Loans. In 1984, Congress examined thoroughly the taxation of policy holder loans, and decided that the limitations imposed by the new definition of life insurance were sufficiently rigorous to eliminate the investment-orientation of certain contracts and perceived abuses.

. Deferred Annuity Tax. By imposing recapture penalties and other restrictions in TEFRA and DEFRA on early distributions from annuity policies, Congress has assured that those policies will continue to serve their basic function, providing ways Americans can save for retirement, rather than become short-term investments. The Congress adopted this approach on the belief it would be effective, and it should be given the opportunity to work. The taxation or partial taxation of the increase in an annuity's value, as proposed by the Administration last May and the Ways and Means staff last September, would not further the retirement income goal or foster development of equitable tax treatment; it could, however, destroy the product.

. Employer-Provided Group Term Life Insurance Taxation. Like other life insurance taxation provisions, Congress thoroughly and specifically examined the tax status of employer-provided group term life insurance in 1982 and as recently as last year. It concluded that the $50,000 exclusion was appropriate and should be preserved. There has been no recent evidence of abuse that would warrant re-examination of that issue now.

. Life Insurance Reserve. In enacting DEFRA, Congress provided a new way of calculating the tax deduction for policy reserves that life insurance companies were compelled to adopt. As a result of extensive effort and cooperation on the part of the Congressional tax-writing committees and the life insurance industry, Congress reduced the reserve deduction permitted to insurance companies to the minimum reserves permitted by prevailing state law. This reduction was part of the DEFRA process, and, although many companies had reservations about the approach, it was accepted.

The method considered in the President's proposal -- allowing reserve deductions only for increases in cash value -- does not recognize the higher liabilities insurance companies must hold under state law, and represents a flawed application of cash basis tax principles in an inappropriate context. This is not a partisan analysis; at its June, 1985 meeting, and again in testimony before the Ways and Means ~~this~~ Committee, the National Association of Insurance Commissioners expressed these and other concerns, and publicly opposed this method.

Social and Economic Effects of Proposed Legislation

The proposed life insurance policy tax would undermine the public policy served by permanent life insurance, deferred annuities and group-term life insurance by causing undesirable social and economice affects.

As noted previously, the vast majority of permanent insurance is purchased by middle-income taxpayers for death protection. That protection answers a critical social need that would go unmet if permanent insurance became unaffordable. In addition, the Administration's May proposal would work a particular hardship on older people, because cash values and, therefore, the tax bite, would increase as time goes by. Since term insurance cannot fill the insurance needs of the elderly, and permanent insurance purchased late in life would cost too much, responsibility for providing family financial security would switch from the private sector to the government. And without the capital that cash values represent, the insurance industry's major role in capital formation (as a supplier of long term capital) would be severely reduced or eliminated.

The Ways and Means staff policy loan proposal would most adversely affect middle- and low-income policy holders, because that group owns the vast majority of life insurance policies with loan values (e.g., 66 percent of permanent life insurance policies purchased in 1985 were on the lives of individuals earning less than $25,000 annually). That group would be among those least able to afford an additional tax burden when it became necessary to borrow funds. Policyowners may find it necessary to surrender needed life insurance protection at a particularly critical time so that funds would be available to pay the tax.

The deferred annuity provisions proposed by the Ways and Means staff fail to achieve equitable tax treatment of qualified and nonqualified retirement plans, and would result in vastly inconsistent tax treatment of contract holders. They would be impossible to administer, as well, because an issuing insurer has no way of knowing whether an applicant for a contract owns any other annuity contracts issued by other companies. In addition, the reporting and compliance costs, which represent the third modification in compliance procedures in four years, would be expensive and burdensome, with little or no revenue to be gained under the provision by Treasury.

The worst effect of both the Administration's and Ways and Means Committee Staff's proposals would be the discouragement of retirement savings. And that would represent a cost that government must eventually bear. At a time when every effort should be made to shift the generation of retirement income to the private sector, legislative proposals like this are hard to fathom.

Repealing the current tax exclusion for group term life insurance, as the Staff Options suggest, could discourage many workers from continuing this coverage and weaken employer-provided plans. This could produce an increase in demands on Social Security and other government income support programs.

Conclusion

The proposals to tax permanent individual and group term life insurance and deferred annuity policyowners and to limit the reserve deduction to cash value increases, as well as the other life insurance proposals, is a case of reinventing the wheel. Congress effectively dealt with the issue in its 1982 and 1984 tax reform legislation. These laws should be given time to work, and taxpayers should be allowed tax certainty. The proposal to tax life insurance policyowners hinges on a faulty concept of life insurance as an investment. It violates the principles of never taxing unrealized appreciation in value. More important, the proposal would have a devastating social and economic impact that cannot be justified. The new wheel, in short, would no longer be round.

New York Life strongly urges that the proposals to change life insurance taxation be rejected by Congress.

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10/11/85

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Charlie Powers
National Quality Award

Million Dollar Round Table

October 10, 1985

Mrs. Betty Scott-Boom
Senate Finance Committee
219 Dirkson Senate Building
Washington, D. C. 20510

Dear Chairman:

Writing in reference to the tax reform bill, as related to life insurance.

Being a life insurance agent for 17 years and wanting to continue in my profession gives me a reason to be concerned with any income tax changes which effect the insurance business.

More importantly, being a concerned citizen of the United States makes me want to express an opinion which may differ from the usual insurance company or agent statements.

The main issue when considering the income tax on the inside growth of cash value in an individual life insurance contract, is what this will do to the life insurance companies. Pooling of small amounts of capital in the life insurance companies has been one of the best ways for the United States to have capital formation. This capital formation has been very important in keeping the country strong through many different economic times and conditions.

The formation of capital has been in my view one of the main reasons the United States has remained a free society. Because the various states regulate the insurance companies and because most companies regulate themselves, the insurance business has remained strong and stable.

Insurance companies do not look outside the United States to loan money. Insurance companies do not speculate with contract owner premium payments.

Let's suppose that thru tax reform the life insurance contract owners cannot enjoy the tax deferred growth that they have in the past. Many citizens will decide to stop depositing monies with insurance companies; this could have an immediate benefit for collecting revenue, however the long view cannot be positive for the continued stability of life insurance companies and our country.

A policyowner who owned a life insurance contract with a mutual life insurance company has paid and continues to pay current income tax on the interest his dividend earned, if he so elected to earn interest on that dividend. This has always been so and I believe should continue.

How my view differs from most insurance companies and agents is that a contract which is structured thru interest only growth, should be taxed as the interest is earned. The new contracts are very attractive to" purchasers of life insurance. These contracts commonly called Universal Life or Variable Life in my opinion should be taxed as monies are earned.

I realize many companies have used the new concepts to keep themselves competative and operating - and to change the way these contracts are taxed would cause many of the companies to have financial difficulty. However in time thru mergers, these companies would survive and still operate within the insurance community.

Most recent changes in the banking laws have enabled these financial intermeditaries to operate more competitively and this has had a positive effect for the American people.

The allowance of tax deferred interest earnings thru Universal Life contracts has created a false competative position for the life insurance community. This contract which can change the amount it charges to the insurance elements within itself can work to the detriment of the policy owner. Higher mortality cost in later years due to very agressive underwriting risk practices could cause a false security position in the owner's later life. The competative marked place these contracts thrive in has been subsidized by the tax law which allows for their interest earnings to be income tax deferred.

To change the income tax law for all life insurance contracts - thereby taxing the inside build up of cash values is wrong, when the issue is really the new contracts which pay interest, which grows income tax deferred.

Any changes in the income tax treatment of life insurance contracts should be directed to this issue; I realize it is a harder issue to address by itself, than just saying all contracts should have their cash value taxed currently. But if changes need to be made to collect more revenue and if you believe as I do that the life insurance companies need to remain strong in the United States for our mutual enjoyment of life, liberty and the pursuit of happiness then you will share my view and concern for this most important matter.

Most respectfully submitted,

Charlie Powers

Charlie Powers

WRITTEN STATEMENT
OF
ROGER JOSLIN
VICE PRESIDENT AND TREASURER
OF
STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY
FOR THE
SENATE COMMITTEE ON FINANCE

October 15, 1985

State Farm Mutual has been a national leader in the property and casualty insurance industry for many years, and we wish to offer our cooperation and assistance to the Committee in your consideration of the impact of current tax reform proposals on our industry.

While State Farm Mutual acknowledges its early roots by continued membership in the National Association of Mutual Insurance Companies, we traditionally develop an independent position on major legislative proposals. We share many of the same concerns expressed by the industry trade associations.

We do not underestimate the complexity and difficulty of the task confronting this Committee and our industry. The property and casualty insurance industry is in many ways unique: the marketplace is highly competitive, closely regulated and very diverse in its structure. Further, property and casualty insurance plays a significant economic and social role in the life of the nation. We sincerely hope we can all work together so as to achieve a fair, sound and lasting resolution in response to the proposals now being considered by this Committee.

In the body of my statement, I will briefly review the nature of the property and casualty insurance industry and State Farm Mutual's place in it; suggest important factual and policy considerations relevant to the Committee's work; and address the specific proposals which have been put forth by the President and others, including the recent options offered by the staff of the House Ways and Means Committee.

The State Farm Mutual Group of Companies

State Farm Mutual Automobile Insurance Company, the parent company of our group, is a "mutual" property and casualty insurance company. The other major insurance companies in our group, while organized as stock companies, are wholly owned subsidiaries of the parent company.

The State Farm Mutual group of companies is essentially a "pure" insurance group, *i.e.*, we have no significant business operations other than insurance.

The State Farm Mutual Group primarily writes personal lines of insurance and insurance for small businesses. These lines include automobile, homeowners, commercial multi-peril, accident and health, and life insurance.

The Property and Casualty Insurance Industry Generally

It is important to understand the diversity of the property and casualty insurance industry. It is comprised of stock, mutual and reciprocal insurance companies. Stock insurance companies, like other businesses conducted in the corporate form, are owned by shareholders who commit their capital to the enterprise and expect a dividend return on their equity investment. Mutual companies are owned by the policyholders who purchase insurance from the company. Reciprocals are a unique form of business organization managed by an "attorney-in-fact" which usually is a corporation organized for profit.

Although it is difficult to determine exactly, we estimate that there are now more than 3,600 property and casualty insurance companies operating in the United States. Approximately 1,700 are mutual companies. The mutual companies range in size from very small township and county companies, normally excluded from industry statistics, to large national organizations like State Farm Mutual. Stock and reciprocal companies also vary greatly in their size and characteristics.

The amount of property and casualty insurance premiums paid each year by the American public is quite large. In 1983 about $110 billion in premiums were paid to the 2,200 insurance organizations (excluding approximately 1,400 small mutual companies) covered by A.M. Best Company's Insurance Reports and Aggregates and Averages. Stock companies comprise approximately 69% of these aggregates, mutuals about 25%, and reciprocals slightly more than 6%.

In recent years, the industry as a whole has experienced substantial losses from its underwriting activities. Until last year, investment income has offset losses from underwriting.

Important Factual and Policy Considerations in Review of Property and Casualty Insurance Taxation

We approach these hearings with the premise that an essential element of tax policy must be to distribute the necessary Federal income tax burden fairly and equitably within the business community and the nation at large. State Farm Mutual accepts its responsibility to pay a reasonable level of taxes, but we consider it crucial that all property and casualty insurers share fairly in the Federal tax burden on our industry. Our taxation system must not distort the competitive structure of the industry.

No major tax legislation directly affecting our industry has been enacted since the Revenue Act of 1962. Since 1962, the total amount of premiums written has increased dramatically, and the size and character of insurers have changed as well. The nature and amount of insured property and casualty risks in America have also changed significantly in 20 years, as obviously have investment conditions and practices. As this Committee knows all too well, the size, significance and complexity of the Federal tax system have also increased; and the pressures on that system to collect huge amounts of revenue have never been greater. In short, the facts and circumstances and the policy considerations relevant to this area have changed dramatically.

In light of these changed conditions, we believe the Congress and the President should adhere to a common base of factual understanding and a common set of policy principles in evaluating property and casualty taxation and making judgments as to possible changes. With the purpose of aiding this endeavor, we suggest that these considerations should at a minimum include the following:

1. Property and casualty insurance is a unique business from a tax perspective. Unlike manufacturing, the price of our product is set well before our most significant costs (i.e., claims) can be known. Unlike life insurance, where future claims can be predicted accurately based on life expectancy, our loss experience is highly variable and is very difficult to predict. The tax law now recognizes our uniqueness and includes rules to reflect appropriately our characteristics.

2. Property and casualty insurance serves essential economic and social purposes in our society. Tax changes which affect our industry could possibly have a significant adverse impact on society as a whole. Accordingly, insurers and the insurance they offer are subject to intense public pressures and demands. For example, we believe the public as well as state insurance regulators demand that insurance be widely available at reasonable costs.

3. The property and casualty insurance industry has historically been regulated at the state level.

This responsibility rests in a Commissioner of Insurance in each of the 50 states and the District of Columbia. These Commissioners pool their expertise through the National Association of Insurance Commissioners ("NAIC"). The major responsibility of the state Commissioners is to insure the financial solvency of insurers: they seek to safeguard policyholders and assure that claims are paid. Federal tax changes must not do violence to state regulatory objectives.

4. The property and casualty insurance industry is by far the major source of investment funds for tax-exempt bonds issued by state and local governments. Tax changes which affect the industry's investment posture could affect its role as a major support of the financial structure of state and local governments.

5. The property and casualty industry is highly competitive. Any tax regime must strive to be neutral in its impact on the various segments of the industry. This principle is particularly important in our industry because of the desirability of encouraging a competitive climate. Competition produces economic and social benefits for the public. Efficiency and profitability must not be penalized; neither large companies operating nationally nor small companies serving local communities

should be unduly burdened. Competition within the United States from foreign-based insurers has grown in recent years and could become even more significant.

6. Mutual companies are significantly different from stock companies: mutuals do not have shareholders' equity and cannot easily gain access to capital markets. By virtue of their form of organization, mutuals provide an important barometer of the health of the industry from a pure insurance standpoint. Congress has traditionally recognized and taken account of these important distinctions, and it must continue to do so.

7. Tax equity and fairness should be guarded carefully in this industry, as in others. Similarly situated taxpayers should pay the same tax, and both taxpayers and the Internal Revenue Service should be capable of making tax determinations with certainty and predictability. Unintended benefits and manipulation of the system should be prevented. Any tax changes should be grounded in tax and social policy principles.

History of Federal Taxation of Property and Casualty Insurance Companies

My testimony before this Committee on June 13, 1983 and my testimony before the House Committee on

Ways and Means on July 19, 1985, outlined the history of the Federal taxation of property and casualty insurance companies, and I refer you to the record in those hearings. At this time I would merely note that the current system of taxing stock companies has not been substantially changed since 1921. Income and expenses for tax purposes are accounted for on the basis of the annual accounting statement appoved by the state regulatory Commissioners, working through the NAIC. The taxation of mutual companies has undergone a greater evolution, but since 1962 mutual companies have been subject to essentially the same tax regime as stock companies, with the exception of the protection against loss ("PAL") account provided to mutual companies. As I will discuss later, the PAL account was enacted in order to take account of the fundamental difference in the organizational characteristics of stock and mutual companies.

Current Proposals

The remainder of this statement will examine, in light of the foregoing factual and policy considerations, the major components of (1) the President's proposals, (2) the Ways and Means Committee staff option, and (3) the premium tax which some have suggested as a possibility.

The President's Tax Proposals

1. Proposed "Qualified Reserve Account" (QRA)

State Farm Mutual believes that the unprecedented QRA proposal is completely unsound from every relevant viewpoint: it does not reflect valid economic considerations; it would produce adverse social consequences; it would be administratively impractical for both the Internal Revenue Service and taxpayers. In the words of California Insurance Commissioner Mr. Bruce Bunner, Chairman of the NAIC Property and Casualty Taxation Task Force: "It is neither fair nor simple, nor will it prove to be a catalyst to economic growth."

Others have presented in detail the many reasons why QRA is fatally flawed. We will not repeat them all here, but would like to emphasize the following:

- QRA is designed to impose an indirect tax on the unearned future investment income of property and casualty insurers. It would violate the fundamental principle that the Federal income tax should be imposed only on economically realized income.

- Not only would QRA tax future, taxable investment income, it would also tax future tax-exempt income from state and local municipal bonds held by property and casualty insurers. State Farm Mutual has no objection to the President's proposal to repeal the exemption for nongovernmental bonds, such as industrial development bonds and mortgage subsidy bonds. But since the proposal would retain the historic tax exemption for public purpose governmental obligations, we believe that all taxpayers -- including property and casualty insurers -- should be allowed to benefit from such investment opportunities without differential treatment.

- As undesirable as QRA is for all property and casualty insurance claims, it is particularly inappropriate for short tail claims, because such claims do not present the "time value of money" issue at which QRA is directed. In the majority of cases that arise in State Farm Mutual's lines of insurance, a policyholder will incur a loss, make a claim and receive payment of that claim, all within a few months. The bulk of our losses are incurred and paid within two taxable years.

- It is significant that the accounting profession has not adopted discounting for unpaid property and casualty insurance claims. The discounting issue has been under study for several years by NAIC, the Financial Accounting Standards Board, and the American Institute of Certified Public Accountants. None of these organizations has taken the position that reserves for unpaid losses must be discounted.

- Finally, we are extremely perplexed by the proposal to allow insured taxpayers to deduct their losses "as if the loss were uninsured." This unprecedented idea is apparently intended as a logical extension of the QRA concept to the insured; yet, if there is any logic here (which we doubt), we do not believe this aspect of QRA is sound policy. This suggestion will cost the Treasury important revenues and will create an administrative nightmare for the Internal Revenue Service as it attempts to value each and every claim asserted against an insured business.

In summary, we feel strongly that QRA is quite simply unacceptable.

2. Proposal To Repeal the "PAL" Account and Other Small Mutual Company Provisions

In each of the several different structures for taxing property and casualty insurers adopted in the past, Congress has given recognition in one fashion or another to the different characteristics of stocks and mutuals. In 1962, the protection against loss, or "PAL," account was introduced for just this reason.

The PAL account is not a tax exemption: rather, it is a limited deferral mechanism. It is designed to compensate for the mutual company's lack of access to the capital market for funds with which to pay losses. In 1962, this Committee described the need for the PAL account as follows:

> "While a stock insurance company can pay extraordinary losses not only out of its accumulated profits but out of its paid-in capital, a mutual insurance company can pay extraordinary losses only out of retained underwriting income. As a result, a mutual ordinarily retains a portion of its underwriting income each year for this purpose: the remainder is paid to its policyholders as policy dividends. This accumulated underwriting income constitutes its reserve out of which insurance losses can be paid and the existence of such reserves is an important protection to the mutual policyholders."
>
> "Under the law up to this time, no income taxes have been paid on this

> retained underwriting income, except (since 1941) to the extent the excess of the alternative 1-percent tax over the tax on investment income in effect taxed part (all, or more than all) of the underwriting income. Similarly, underwriting losses may not reduce the tax on investment income. Under the President's proposal, underwriting gains would have been fully taxed as realized. Under the provisions of this bill, however, these mutual fire and casualty companies will be permitted to set aside a portion of each year's underwriting gain in a special account for protection against losses. This amount will be available to meet certain losses for 5 years, after which most of any remaining portion will be included in taxable income of the sixth year." S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), at page 55.

The PAL account addresses significant needs of mutual organizations, and any proposals for change must be carefully constructed to take account of these needs. State Farm Mutual concedes that the PAL account could, and perhaps should, be more appropriately limited.

Our company of course does not benefit from the various special tax provisions now targeted to small mutual companies. Nevertheless, we support the retention of these provisions.

3. Proposed Limitation on Deduction of Mutual Company Policyholder Dividends

State Farm Mutual opposes the proposed application to mutual property and casualty insurers of the unique life insurance policyholder dividend disallowance rules. These complex and extraordinary provisions were enacted, as this Committee clearly recalls, in 1984, following several years of intense debate and struggle within the life insurance industry. These provisions were intended to "balance" the tax burden of the stock life companies and the mutual life companies, within parameters deemed necessary. None of this history, and none of the policy rationales agreed upon last year, can have any sound application to property and casualty insurance companies.

As noted above, property and casualty reserves are fundamentally different from life reserves. Property and casualty insurance policies are also not comparable to the various types of financial planning vehicles sold by life insurers.

Stock property and casualty insurers compete very successfully against mutuals. By no stretch of the imagination can it be said that stock companies are disadvantaged in the marketplace because of an unfair relative Federal tax burden. In fact, a strong case can be made to the contrary. As mentioned above, the relative market shares are three-quarters for stocks and reciprocals and one-quarter for mutuals. Yet, over the ten years ending in 1983, according to public information from the A.M. Best Company, it would appear that the mutuals' Federal income tax was in excess of four times the Federal income tax of the stocks. It would also appear that State Farm Mutual's Federal income tax alone was more than twice the amount of all stock companies combined. Also, in 1983, policyholder dividends paid by the 325 mutual insurers in A.M. Best's data base totaled $805 million. In that same year policyholder dividends paid by comparable stock and reciprocal companies totaled $1.4 billion.

Notwithstanding these facts, it is proposed to disallow only the deduction for mutual company policyholder dividends. Far worse, if the life insurance model is blindly followed, a variable and uneven excise tax on the net worth of mutual companies would be imposed, beyond the denial of deduction of policyholder dividends. This would further aggravate the disproportionate tax burden now being paid by mutual companies. The net result of such a proposal, if ultimately adopted into law, can only lead to substantially higher insurance costs for mutual policyholders. We and our more than 25 million policyholders cannot accept this concept.

In sum, we do not wish to see the recent life insurance taxation debate repeated in the property and casualty industry, nor should the resolution of that prior debate be erroneously imposed on our industry. There is no policy or revenue need for such provisions to be applied to our industry. We believe all segments of the industry are in agreement on this conclusion, and we sincerely hope this Committee will concur.

The Ways and Means Committee Staff Option

The option package proposed by the staff of the House Committee on Ways and Means presents problems at least as significant as those of the President's proposals. At the outset, we question the wisdom of any interim approach to tax reform. It would be far better, from the perspectives of Congress, the Treasury and the industry, to establish a coherent, permanent solution.

Moreover, this particular interim approach has little to recommend it. It is a potpourri of many taxation ideas, each one presenting complex and difficult problems of application in practice. On a broad level, the package has little theoretical consistency. On a more pragmatic level, each component of the package could have unexpected and unintended results. If such a package were enacted as an interim measure, taxpayers and the Treasury would be required to devote an inordinate amount of time and resources to working out the intricacies of the option's numerous and complex components. This, it seems to us, would be wasteful.

1. Inclusion of a Portion of Unearned Premiums in Income

As we understand the proposal, property and casualty companies would be required to include a portion of unearned premiums in income. This component of the staff option resembles a proposal put forth by the property and casualty industry, the so-called "revenue offset" proposal. "Revenue offset" would appear to raise revenue without requiring numerous complex definitions and judgments. We believe this system could be workable as a permanent solution. However, we have reservations about including it as only one element of an interim package containing less appropriate provisions.

2. Limit Investment in Tax-Exempt Securities

The proposal to reduce loss reserve deductions in relation to a property and casualty insurance company's investments in tax-exempt securities is clearly wrong as a matter of fundamental principle. The fact that Federal revenues are reduced because of tax-exempt securities is a result of the existence of the exemption itself, and not as a result of investments in such securities by certain insurance companies or by any other particular group of taxpayers. So long as Congress deems that there is a need for a tax exemption for certain securities, insurers should not be singled out and penalized in comparison with other investors for investing in such securities.

We do concede that there may be a problem if a taxpayer and its affiliated entities directly or indirectly borrow to buy or carry tax-exempt securities. State Farm Mutual, however, does not engage in such practices.

Insurance companies play a vital, positive role in society through their investments in exempt securities. Investments in such securities provide the capital required for state and local governments to function.

The property and casualty insurance industry is the largest purchaser of state and local bonds. Any substantial change in the tax treatment of such investments for this industry could impair the ability of state and local governments to raise necessary revenues.

3. Limit on Consolidation with Non-Property and Casualty Entities

The proposed limitation on deductions of property and casualty losses against income of non-property and casualty consolidated affiliates would parallel existing limitations on consolidation of life companies with non-life companies. The revenue attributed to this particular provision by the staff appears to us to be substantially understated.

4. Limit on Net Operating Losses

Assuming that a net operating loss has been created by adherence to existing law, what principled justification can there be for in effect deferring or stretching out the use of NOLs by one industry? Further, the suggested annual limitations on use of NOLs appears defective as a technical matter.

5. Cash Method of Accounting

The Ways and Means Committee staff option states that the cash method is to be phased in with reference to the President's revenue projections for QRA. The operation of this provision is entirely unclear. There appears to be no justification for this proposal other than raising revenue, and we believe it cannot be justified solely on that basis. If taken literally, it is far worse than QRA, and far beyond any approach suggested by anyone appearing before Congress. Drafting clear legislation for partial cash method accounting keyed to a revenue projection several years in the future appears impossible; and there are far too many critical policy and competitive implications justifiably to delegate implementation to writers of regulations. We strongly oppose passage of legislation which purports to put into effect at a future date a completely unjustifiable measure.

In summary, we believe that the Ways and Means Committee staff option package, as drafted, does not present a viable approach to taxing the industry. We urge this Committee to commit itself to developing a full and permanent solution to the problems of our current system, rather than to implement such a haphazard, explicitly "stop-gap" measure.

Premium Tax

Another approach that has been suggested in various quarters is to impose a premium tax on the industry, we assume as an alternative minimum tax.

Many companies are opposed to any proposal which would establish a separate tax and tax rate for insurers, particularly if the tax bears no relationship to economic income. Such a system could impose a tax on a company in a year in which it has actual economic losses. A premium tax is more theoretically consistent with consumption taxes, such as the value added tax, than with the current corporate income tax. It is clear that any form of premium tax proposal will face staunch opposition from the industry.

Conclusion

We recognize that many people believe that there are problems with the current taxation of the insurance industry. We are prepared to work towards sound solutions, and we urge the Committee to think in terms of more appropriate permanent solutions than have been proposed thus far. We are confident that there are viable and fair ways to solve the perceived problems of the tax treatment of the industry, without unduly burdening any segment of the industry and without adverse effects on competition or consumers.

We pledge our cooperation as the Committee proceeds with its task of designing a workable taxation system for our industry and stand ready to provide you with any information and assistance that you may require in this endeavor.

October 11, 1985

WRITTEN SUBMISSION OF
THE STOCK COMPANY INFORMATION GROUP
TO THE COMMITTEE ON FINANCE OF THE
UNITED STATES SENATE
CONCERNING THE PRESIDENT'S TAX REFORM PROPOSALS

This statement on the life insurance provisions of the President's Tax Proposals (the "Administration Proposals") is submitted by the Stock Company Information Group ("SIG"). We ask that it be included in the record of the Committee's October 1, 1985 hearing on the Administration Proposals.

The Stock Company Information Group, a coalition of 24 investor-owned life insurance companies, was organized in 1981 to monitor tax legislative developments and to convey the views of its membership on life insurance tax issues to the various insurance trade associations and the Government. Taking into account its members' affiliated companies, the SIG encompasses a majority of the 50 largest stock life insurance companies in the United States. Representatives of the SIG were privileged to work with members and staff of the Committee on Finance, as well as with their counterparts in the House of Representatives and with officials of the Treasury Department, in the development of the life insurance tax provisions of both the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") and the Deficit Reduction Act of 1984 (the "1984 Act"). A list of SIG member companies is appended.

The Administration Proposals contain a number of suggestions for altering the taxation of life insurance companies and their policyholders. If adopted, these proposals would bring about radical and disruptive changes in tax rules that have prevailed virtually since the inception of the modern income tax. For reasons that we will explore below, we believe these proposals should not be adopted. But, before turning to the merits of the proposals, we regard it as essential to review the recent history of legislation affecting the taxation of life insurance products and life insurance companies. That review will highlight how much has been done in this area in just the past three years.

I. RECENT TAX LEGISLATION AFFECTING LIFE INSURANCE

As part of TEFRA and the 1984 Act, this Committee and the Congress very substantially tightened the rules governing the taxation of life insurance and annuity contracts, and comprehensively revised the rules governing the taxation of life insurance companies.

A. Changes in the Taxation of Life Insurance and Annuity Contracts

With respect to life insurance contracts, Congress added new section 7702 to the Code, defining a life insurance contract for tax purposes, and thereby providing a framework calculated to ensure that the favorable tax treatment historically accorded life insurance would be confined to contracts that furnish a substantial measure of insurance protection, and would not extend to those that might operate as investment vehicles. With respect to annuity contracts, Congress altered the applicable tax rules, and imposed new penalty taxes, all in a manner intended to assure that the treatment historically accorded annuities would be confined to contracts used to provide retirement income, the purpose for which annuities historically have been used and which they are uniquely suited to fulfill.

These changes, collectively, have operated to preserve the tax treatment which, for sound reasons of national policy, the Congress has always seen fit to extend to these contracts. At the same time, they have established a framework which, we believe, will ensure that this favorable tax treatment is available only to those insurance products that fulfill their historical purposes.

B. Changes in the Taxation of Life Insurers

Of equal importance, the 1984 Act completely revised the taxation of life insurance companies. It substituted for the multi-phase scheme that had prevailed since 1959 a simpler, more easily understood structure whose principal objectives were to achieve a reasonable measure of the taxable income of life insurers; to tax life insurance companies in a fashion that created neither an advantage nor a disadvantage for those enterprises vis-a-vis other financial institutions; and to tax both stock and mutual life insurers in a way that did not create any advantage for one group vis-a-vis the other.

As part of this legislation, Congress concluded that among the fundamental objectives of the legislation would be to collect an aggregate of $3.1 billion in tax from the life insurance industry in 1984. And, given the very considerable difficulties inherent in taxing mutual life insurers, Congress reached an equally fundamental decision that, of the $3.1 billion to be paid by the life insurance industry in 1984, 55 percent -- or $1.7 billion -- was to be paid by mutual life insurance companies, which dominate the industry. The remaining 45 percent -- $1.4 billion -- was to be paid by the stock segment of the industry.

To achieve these objectives, the 1984 legislation contained three pivotal provisions. Two of these were the 20 percent "special life insurance company deduction," and the additional "small life insurance company deduction," which together were generally designed to fix the tax to be collected from the industry at $3.1 billion. The third fundamental provision was new section 809 of the Code. This provision imposed a limitation on the deductibility of policyholder dividends by mutual life insurance companies, and was designed to assure that the mutual segment of the industry would in 1984 pay the intended 55 percent of the industry's total tax burden.[1]

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[1] See S. Prt. No. 169 (vol. I), 98th Cong., 2d
(Footnote continued)

II. THE ADMINISTRATION PROPOSALS

Now for the third time in just four years, and despite the level of recent activity, we are faced with an initiative which again would introduce major changes in the tax treatment of life insurance companies and their policyholders. The Administration Proposals would undo most of the major tax rules affecting life insurers that Congress adopted just last year. To support its recommendations for altering the taxation of policyholders and insurance companies, the Administration argues that, if enacted, the tax laws could be simplified and tax rates lowered. In fact, the proposals relating to insurance and annuities will not contribute to simplifying existing law, and will lead to increased taxes on products that provide important financial security. In addition, these changes would reverse long-standing policies to encourage the growth of private retirement and life insurance protection.

The SIG is concerned with the adverse impact of the Administration Proposals on the insurance industry and its customers. Our concerns in this regard are addressed in detail in the October 1, 1985 testimony presented by the American Council of Life Insurance (the "Council"). We agree with and endorse the Council's statement. We also endorse the joint state-

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[1] (continued)
Sess. 549-550 (1984).

ment of the Life Insurers Conference, the National Association of Life Companies, and the National Insurance Association which was filed for the record of the October 1 hearing.

In what follows, we simply wish to emphasize the criticisms of these proposals that we consider most telling. We will direct our comments, first, to the Administration Proposals to impose a new tax on life insurance and annuity holders. We will then address those aspects of the proposals that would change the taxation of life insurance companies.

A. Proposals to Tax Policyholders

Chapters 10.06 and 10.07 of the Administration Proposals recommend the imposition of a new tax on life insurance and annuity policyholders. Under this proposal, the owner of a life insurance or annuity contract would be treated as being in constructive receipt of the contract's cash surrender value -- and thus be taxed on the so-called "inside build-up."

Under existing law, which dates back to 1913, the owner of a life insurance or annuity contract is taxed only when certain contract distributions occur, not simply on the crediting of amounts to contract cash values. This follows from application of the time-honored doctrine of "constructive receipt," which holds in part that potentially taxable gains that are "locked up" in property, and are therefore not reducible to cash without the surrender of valuable rights in that property, do not properly constitute income currently subject to tax. Thus, in the case of a life insurance contract, only the proceeds distributed on surrender of the contract, less the premiums paid for it, are includible in the owner's gross income (i.e., the "gain" built up in the contract is includible). Moreover, as a matter of legislative grace, effectuating national social policy dating back to 1913, and reaffirmed by Congress as recently as last year, the death benefit paid under a life insurance contract is not income in the hands of the beneficiary. For any of the foregoing rules to apply, however, such a contract must satisfy the tax definition of "life insurance contract," which Congress added (as section 7702) to the Code in 1984. As we already noted, that definition was enacted, in lieu of taxing the inside build-up, to confine the application of these rules to contracts that provide a substantial measure of insurance protection and to distinguish from such contracts those instruments that might operate as investment vehicles.

In the case of an annuity contract, under rules substantially revised in 1982 and again in 1984, undistributed amounts likewise do not attract tax, though amounts distributed prior to annuitization are includible in gross income to the extent the contract's cash value before the distribution exceeds the premiums paid (i.e., to the extent that any "gain" has accumulated under the contract). Any such income may also be subject to a five percent penalty tax. For this purpose, loans taken against the security of an annuity contract are treated as distributions. Again, these rules were enacted, in lieu of taxing the inside build-up, to assure that the deferral of tax historically accorded to annuity contracts would be confined to contracts used to provide retirement income. Furthermore, to curb any potential for continuing deferral of tax after the death of an annuity contract owner, the 1984 Act also added a provision requiring distributions to be commenced at the time of the owner's death.

Since the Administration Proposals, if adopted, would override the doctrine of constructive receipt in the case of life insurance and annuity contracts, they would materially reduce the availability of life insurance and annuity products, with attendant social and economic consequences that would be substantial. These proposals also would depart from well-settled tax principles that they otherwise generally continue to accept, such as the long-standing and understandable hesitation to levy a tax on "income" that only theoretically exists in a taxpayer's hands (since the tax must be paid with cash rather than with theories). The need to pay tax currently on gains locked up inside an insurance or annuity contract would present a very real problem here. Further, and perhaps most importantly, the tax policy concerns that the proposals apparently seek to address have already been satisfied by the actions that Congress took in 1982 and 1984. For these and other reasons more fully developed in the statement of the Council, we believe these proposals should not be adopted.

B. Proposals to Change Life Company Tax Rules

The Administration Proposals also would alter in a radical way the rules for taxing life insurance companies that the Congress, led by this Committee, comprehensively revised last year. The Administration apparently contends that the 1984 revision was defective. It seems to be saying that this Committee (and, for that matter, the Treasury itself) endorsed, and the Congress adopted, a set of provisions for life insurers that have caused their income to be understated for tax purposes. It would therefore have this Committee: (1) discard much of the deduction for life insurance reserves, a deduction which dates back over 70 years and which this Committee spent considerable time refining during the 1983-1984 revision; (2) apply a "qualified reserve account" approach to life insurers' unpaid losses; (3) repeal the new 20-percent "special life insurance company deduction"; and (4) repeal the equally new "small life insurance company deduction." The Administration seems to forget that it, too, played a major role in the crafting of these provisions and publicly endorsed them at the time this Committee considered them.

We think that adhering to the Administration's lead in these respects would be a mistake, and we strongly urge you not to do so. As a supplement to the Council's statement, and to the joint statement of the Life Insurers Conference, the

National Association of Life Companies, and the National Insurance Association, we offer the following observations on these four proposals.

1. Deduction for Life Insurance Reserves

Under current law dating back to 1909 and as revised last year, life insurance companies are allowed a deduction from taxable income for any net increase in life insurance reserves, and must include in income any net decrease in those reserves. Under the 1984 revision, the deductible life insurance reserve for a life insurance, annuity, or noncancellable or guaranteed renewable accident and health insurance contract is the greater of (1) the net cash surrender value of the contract (net, that is, of any surrender penalty or charge), or (2) the reserve for unaccrued policy benefits determined under a prescribed set of rules (based on prevailing State regulatory requirements) relating to reserve method, assumed interest rate, and assumed mortality or morbidity rate.

Chapter 10.08 of the Administration Proposals would generally limit the deductible life insurance reserve for any contract to the net cash surrender value of the contract (though there would be an exception for annuity contracts in pay-out status). Thus, under the Administration Proposals, a portion of the reserves held for some, though not all, life insurance and annuity contracts would currently be deductible, and none of the reserves for unaccrued benefits under accident and health insurance contracts would be deductible.

We think it important for this Committee to consider the proposal in the context in which it arises. First of all, the very same suggestion was made by the Treasury Department during the formative stages of what became the life company rules of the 1984 Act. It was then and there rejected by the Congress (though apparently, in the Administration's view, not forcefully enough).

Secondly, this suggestion is of a piece with the Administration's recommendation to tax the inside build-up, as discussed above, and its proposal to deal with insurers' unpaid losses under a "qualified reserve account" approach, discussed under heading (2) below. The latter proposal, as others have pointed out (including the Treasury's own economists, who originated the concept), constitutes an effort to place insurers on cash basis accounting for their unpaid losses. The life insurance reserve proposal of Chapter 10.08 essentially amounts to the same thing, particularly in the case of liabilities for life insurance policies that lack cash values and for accident and health contracts. The insurer would receive no life insurance reserve deduction at all for these contracts; would report all premiums and investment earnings as income when received, without regard to the liabilities the premiums generate, and would deduct the liquidation of those liabilities (the claims) only as and when they are paid; and would therefore operate on a cash method of accounting with respect to such contracts for tax purposes.

The sole "complication" introduced in the Chapter 10.08 proposal relates to the allowance of a deduction for any net increase in cash values. This arises, as best we can tell, from a desire to be consistent with the proposal to tax the inside build-up on the theory that insurance contract cash values are tantamount to bank accounts. Since banking institutions do not have taxable income to the extent of receipts applied to liabilities to customers, insurers, according to the Administration, would receive comparable treatment. Were it not for this, Chapter 10.08 would be proposing the total abolition of the deduction for life insurance reserves.

It is unclear to us, in the first instance, why this Committee would wish to re-open the life insurance reserve deduction now, when the ink on the 1984 enactment is barely dry, simply because the Administration is not satisfied with what it agreed to last year and wants another opportunity to secure what it already has proposed and lost. We think the rules enacted last year, limiting the life insurance reserve deduction to the minimum reserve amount required by State regulators, are appropriately strict and provide for a fair statement of an insurer's economic income with respect to the liabilities it has taken on. Life insurance companies have already expended considerable resources on the implementation of these rules. It would be wrong to abandon them now.

As the Council has also pointed out, the proposal to limit the life insurance reserve deduction to cash surrender values is contrary to over 70 years of tax policy and practice. This history reflects the need to recognize the long-term nature of life insurance, annuity, and noncancellable and guaranteed renewable accident and health insurance contracts. It likewise reflects the need to provide tax rules to ensure that income and deductions are properly matched. Existing law appropriately recognizes that insurers must set aside funds to provide for various forms of liabilities under long-term contracts which provide no cash values. If deductions are not allowed for these liabilities, life insurance companies will pay tax on premiums, when received, but will be limited to deductions for related claims when such amounts are paid many years later. Substantial mismatching of income and deductions would result. The same would be true of reserves held for contracts that have cash values where those reserves exceed the cash values.

Curiously, while the Administration Proposals would place a life insurance company on a cash basis of accounting with respect to many of the products that it sells, elsewhere the Administration rejects cash method accounting for its failure to reflect the economic results of a taxpayer's business over a taxable year. We will say more about this momentarily. For now, we can simply state our agreement that cash method accounting, at least where life insurance companies are concerned, would incorrectly measure economic income. We therefore urge you to reject the proposal of Chapter 10.08.

2. Deduction for Unpaid Losses

Under current law which (like the provision for deductibility of life insurance reserves) dates back to 1909, insurers are allowed to deduct their unpaid losses, that is, the amounts they set aside for the future payment of accrued claims. For life insurance companies, these relate principally to accrued claims under accident and health insurance contracts. These contracts provide protection against such contingencies as medical expenses and disability. Individual policies of this sort typically provide long-term protection so long as the policyholder continues to pay premiums. The vast majority of Americans are protected by some form of health insurance whether it be provided under a group contract, or under individual policies covering, among others, employees of small businesses, the elderly supplementing Medicare, professionals, the unemployed, and dependents not covered by group insurance. Such coverages are designed to protect against loss of income or large medical expenses, just as life insurance benefits protect against the death of an income provider.

The tax treatment of many of the reserves held under accident and health insurance contracts was changed just last year as part of the overall revision of the tax rules for life insurers. As a result, individual accident and health insurance reserves are now determined, for tax purposes, in accordance with the State minimum reserve requirements. Additionally, for tax as well as State regulatory purposes, group claim reserves typically are determined on an actuarial basis, using an assumed interest rate, and are of very short duration.

The Administration Proposals would now change this, too, and effectively would abolish such reserve deductions. Chapter 10.10 would apply a "qualified reserve account" (or "QRA") approach to life insurers' unpaid losses, to the extent such amounts are "not included in life insurance reserves." While we endorse the testimony of the Council on this subject, we would like to offer a few observations of our own.

The rather complex QRA mechanism of accounting for unpaid loss reserves is nothing more than an elaborate device by which to impose cash accounting on these reserves. Consistently with the Administration's proposed treatment of life insurance reserves, it effectively would abandon any effort to match the revenues and expenses of life insurance companies, and would seriously mismeasure their income for tax purposes.

In operation, the QRA proposal would limit a life insurance company to deducting only an initial addition to its reserves for unpaid losses incurred during a taxable year. Thereafter, the company's QRA would be required to be augmented each year by additional amounts based on the company's after-tax rate of return on portfolio investments. In contrast with the initial addition to the QRA, however, no deduction would be allowed for such subsequent additions. At the time a claim was paid, the entire reserve -- including both the initial addition for which a deduction was allowed, and subsequent additions to the reserve for which no deduction had been allowed -- would be includible in income, and the company would be permitted a deduction for payment of the claim.

The simple fact of the matter is this: in operation, QRA accounting is precisely the equivalent of cash accounting for the unpaid losses. Indeed, the Treasury Department concedes as much.[2] Thus, for this Committee to impose QRA accounting on unpaid losses would be tantamount to denying them any deduction for their unpaid losses until actual payment of the underlying claims.

As respects insurance companies, the Administration Proposals appear to be quite enamored with the "cash-equivalent" system that would be imposed through QRA accounting. They have proposed its wholesale application to the loss reserves of property-casualty insurers as well as to those of life insurers. But the Administration has advanced no persuasive reason why cash (or QRA) accounting is an appropriate method of accounting for the unpaid losses of insurance companies.

Indeed, it is quite ironic that the Administration has even proposed the application of QRA accounting to the activities of life insurers, much less to those of property-casualty insurers. These organizations, more so than any others, are engaged in activities that involve the collection of income in advance, giving rise to obligations to pay losses in the future. Subjecting such organizations to cash-equivalent accounting would lead to very serious mismatching of their revenues and expenses, and would seriously mismeasure their income.

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[2] See T. Neubig and C.E. Steuerle, "The Taxation of Income Flowing Through Financial Institutions: General Framework and Summary of Tax Issues" (United States Treasury Department, Office of Tax Analysis, OTA Paper No. 52, 1983), at 63-68. Neubig and Steuerle's paper demonstrates that identical financial results are obtained through the use of either cash accounting, or what they describe as a "qualified reserve method" of accounting, for future liabilities. The latter is QRA accounting.

The irony is that the Administration, in other respects, is quite skeptical about the propriety of cash accounting, which, according to the Administration's Proposals:

> "frequently fails to reflect the economic results of a taxpayer's business over a taxable year. The cash method simply reflects actual cash receipts and disbursements which need not be related to economic income. Obligations to pay and rights to receive payment will be disregarded under the cash method, even though they directly bear upon whether the business has generated an economic profit or loss. Because of its inadequacies, the cash method of accounting is not considered to be in accord with generally accepted accounting principles and, therefore, is not permissable for financial accounting purposes."

In response to these concerns, the Administration Proposals would seriously restrict the availability of cash accounting for other businesses. Presumably they have done so to ensure that, through more widely mandated use of accrual accounting, taxpayers will be more likely to report something akin to "economic income" for tax purposes.

Given the Administration's disenchantment with cash method accounting, and its preoccupation with matching revenues and expenses, it is difficult to understand -- except, perhaps, in terms of a result-oriented preoccupation with raising revenue -- how the Administration can seriously advocate cash-equivalent accounting for unpaid losses of life insurance companies. The existing treatment of life insurers' loss reserves does operate to match revenue and expenses and therefore is decidedly superior to QRA accounting. Departing from this treatment in favor of a QRA approach is all the more questionable with respect to accident and health reserves, which are determined employing rates of interest and morbidity and/or mortality.

We would add one final comment about application of the QRA methodology to life insurance companies. Life companies are, and since 1959 have been, taxed under a regime that expressly "prorates" taxable and tax-exempt income between the companies and their policyholders. The QRA would achieve the same end, though indirectly (as specifically noted on page 268 of the Administration Proposals). Applying QRA to life insurers would thus result in a doubling-up of proration. Clearly this would be wrong. Unfortunately, the Administration Proposals neither acknowledge this result nor attempt to defend it.

3. Special Life Insurance Company Deduction

Under a provision of the tax law introduced last year, a life insurance company is allowed a "special" deduction in an amount equal to 20 percent of its otherwise taxable income. Since the deduction applies only with respect to income resulting from the company's life insurance business, gains and losses arising from a noninsurance business operated by a life insurance company neither increase nor decrease the amount of this deduction.

As we noted at the outset of this statement, the special life insurance company deduction was designed to limit the total tax revenues from the life insurance industry in 1984 to approximately $3.1 billion. The deduction thus serves, in effect, to lower the effective corporate tax rates in the case of life insurers -- reducing the top rate from 46 percent to 36.8 percent on life insurance business income. In so doing, the deduction was intended in part to place life insurance companies on a somewhat more equal footing (a "level playing field") with competing financial intermediaries which enjoy effective tax rates lower (in some cases, substantially lower) than the nominal rates.

Chapter 10.09 of the Administration Proposals would repeal this new deduction, arguing that changes the Proposals recommend in the tax treatment of other financial institutions would produce a level playing field without the special deduction, thereby rendering it unnecessary. We strongly disagree. The Administration Proposals do not achieve equality of tax treatment among all institutions which sell insurance or provide financial services. Under the Proposals, many direct competitors of life insurance companies would retain their tax-favored or tax-exempt status, and will be able to operate at a very significant competitive advantage over life insurance companies.

Indeed, some of the most dominant organizations operating in these fields would, under the Administration Proposals, remain tax-exempt. The Blue Cross-Blue Shield organizations, for example, collectively represent perhaps the nation's largest single private purveyor of accident and health insurance. Although under the original Treasury Department proposals the existing tax exemption of Blue Cross-Blue Shield (under section 501(c)(4) of the Code) would have been repealed, the actual Administration Proposals abandoned this proposed change. As a result, the single largest competitor in the accident and health field will remain tax-exempt, and will be able to operate at a competitive advantage vis-a-vis life insurers even if the special life insurance company deduction is retained. If this deduction were to be repealed, the competitive disadvantage would seriously be exacerbated. As the Committee on Ways and Means observed in its report on this aspect of the 1984 legislation, the special deduction "insures that life insurance companies remain competitive with other tax-favored and tax-exempt financial intermediaries (e.g., banks, thrift institutions, self-insurance trusts, Blue Cross-Blue Shield, etc.)."[3] Although the Administration proposes to repeal certain tax benefits and deductions enjoyed by some financial institutions that compete with life insurance companies, it is by no means certain that the Proposals, even if enacted in their entirety, would eliminate the tax-induced competitive imbalance. Without a much clearer definition of the proposed tax changes for these institutions, as well as a thorough study of the impact that these proposals would have on effective tax rates, there can be no assurance that the Proposals would accomplish their theoretical goal of equal treatment for all businesses which sell insurance or provide financial services.

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[3] See H.R. Rep. No. 432 (pt. 2), 98th Cong., 2d Sess. 1407 (1984).

Having said this, let us make clear our belief that the proposal to eliminate the life insurance company special deduction should be reviewed in the context of the actual effect that any changes made in the tax law would have on the treatment of other financial intermediaries. If the overall changes do, in fact, increase the taxes paid by other financial intermediaries and place their effective tax burdens on a par with those of life insurance companies generally, it would follow that the need for the special deduction might be re-examined. However, the proposed repeal of that deduction should not be accepted without recalling its origins, namely, that it is needed to place life insurers on a "level playing field" with other financial intermediaries and with competitors in our own business that are expressly exempted from tax. Unless and until these biases are corrected -- and the Administration Proposals stop far short of doing so -- the special deduction should be allowed to stand.

As a final point on this topic, we wish to note that some have suggested adding in the amount of the special deduction as a so-called "preference" item for purposes of an alternative minimum tax applicable to corporations. Since, as we have just explained, the special deduction serves to reduce the effective corporate tax rates in the case of life insurers, and does so specifically to adjust their tax burdens in relation to those of competing entities, we consider this suggestion misguided. It would be inappropriate to treat companies eligible for this rate adjustment as having such a preference item just as it would be inappropriate to treat a corporate taxpayer in the 15 or 30 percent tax bracket (as compared with one in the 46 percent bracket) as having a preference.

4. Small Life Insurance Company Deduction

The law as revised in 1984 permits a small life insurance company a deduction equal to 60 percent of the first $3 million of its otherwise taxable income. This deduction, which is phased out as that income increases from $3 million to $15 million, is allowed only to companies with gross assets of less than $500 million. The Administration Proposals (also in Chapter 10.09) argue that after comprehensive tax reform, special rules for small life insurance companies will no longer be appropriate, and that this deduction, too, should be repealed.

We must also disagree with this conclusion. The small life insurance company deduction was instituted last year as one of the principal elements of the thoroughly studied, carefully balanced set of rules designed to govern the taxation of life insurance companies for years to come. It replaced (together with the 20 percent special deduction) rules under the 1959 law that were vitally important to small life insurance companies in that they permitted small businesses to compete, and to grow, within the life insurance industry. In this regard, it must be remembered that our's is an industry dominated by large firms that control multi-billion dollar asset portfolios, and yet in which numerous small companies play a vital role in maintaining competition and providing innovation. It was to permit the latter to compete and grow in the context of the former that the small life insurance company deduction was enacted. This approach was acceptable to small life insurers even though it was not as favorable as the 1959 law which it replaced.

The Administration's recommended reduction of the tax rates applicable to corporations from 46 percent to 33 percent simply would not be adequate to accomplish for small life insurance businesses what existing law now achieves. By repealing the small company deduction, the Administration Proposals would more than double the effective rate of tax imposed on the small life insurer. The suggested repeal thus fails to take into account the history and purpose of the provision to be repealed.

The proposal to eliminate the small company deduction would also upset yet another fundamental aspect of the intricately woven set of rules for life insurers embodied in the 1984 revision: the division of tax burdens between mutual and stock life insurance companies. This aspect of the work that the Congress performed in 1983 and 1984 was perhaps the most difficult task faced, and the mutual/stock "segment balance" compromise reached was both delicate and critical to the success of the recent legislation. While the small company deduction is available to small mutual companies, it was recognized to inure principally to the benefit of small stock companies. Thus, this provision was a crucial factor in determining that segment balance. Unfortunately, repeal of this deduction would obliterate that factor, change the balance so carefully worked out, and generally undo what the Congress did only last year.

The joint statement of the Life Insurers Conference, the National Association of Life Companies, and the National Insurance Association more fully develops these and other reasons why it would be wrong to repeal the small company deduction. We commend that statement to this Committee and urge you not to agree with this aspect of the Administration Proposals.[4]

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[4] The joint statement also notes that, because (as is the case with the special deduction) the small company deduction adjusts the effective corporate tax rates for the eligible companies, taking competitive conditions into account, it would be inappropriate to include the amount of the deduction as a preference item for purposes of any corporate minimum tax.

III. CONCLUSION

The member companies of the SIG wish to thank the Committee on Finance for this opportunity to express our concerns with the Administration Proposals as they relate to life insurance companies and policyholders. We commend the Committee not only on the work accomplished in 1984 with respect to the life insurance industry, but also on the difficult labors it now faces in attempting to extend such work to all other sectors of economic activity. We wish to emphasize that it is not our intention here to ask for exemption from tax reform efforts, but rather to point out that the Congress, led by this Committee and with (at the time) the Administration's agreement, already completed such efforts for our industry just last year.

STOCK COMPANY INFORMATION GROUP

AETNA LIFE INSURANCE COMPANY
ALLSTATE LIFE INSURANCE CO.

AMERICAN GENERAL LIFE INSURANCE COMPANY

BUSINESS MEN'S ASSURANCE COMPANY OF AMERICA

CAPITAL HOLDING CORPORATION

CNA INSURANCE

CONNECTICUT GENERAL LIFE INSURANCE COMPANY (CIGNA)

FEDERAL KEMPER LIFE ASSURANCE COMPANY

FRANKLIN LIFE INSURANCE COMPANY

HARTFORD LIFE INSURANCE COMPANY

E.F. HUTTON LIFE INSURANCE COMPANY

IDS LIFE INSURANCE COMPANY INSURANCE COMPANY

INTEGON LIFE INSURANCE CORPORATION

JEFFERSON STANDARD LIFE INSURANCE COMPANY

LIBERTY LIFE INSURANCE CO

LIBERTY NATIONAL LIFE INSURANCE COMPANY

LIFE INSURANCE COMPANY OF VIRGINIA

LINCOLN NATIONAL LIFE INSURANCE COMPANY

PAUL REVERE LIFE INSURANCE COMPANY

PROVIDENT LIFE AND ACCIDENT INSURANCE CO.

SOUTHWESTERN LIFE INSURANCE COMPANY

TRANSAMERICA OCCIDENTAL LIFE INSURANCE COMPANY

TRAVELERS INSURANCE COMPANY

WASHINGTON NATIONAL

October 15, 1985

STATEMENT OF
SUN LIFE ASSURANCE COMPANY OF CANADA (U.S.)
AND
MASSACHUSETTS FINANCIAL SERVICES
IN OPPOSITION TO
THE PRESIDENT'S PROPOSAL TO TAX THE "INSIDE BUILD-UP" ON DEFERRED ANNUITY CONTRACTS
TO
COMMITTEE ON FINANCE
UNITED STATES SENATE
OCTOBER 1, 1985

This statement is submitted by Sun Life Assurance Company of Canada (U.S.) ("Sun Life (U.S.)"), a wholly-owned subsidiary of Sun Life Assurance Company of Canada, and by Massachusetts Financial Services ("MFS"), a wholly-owned subsidiary of Sun Life (U.S.).[1] Sun Life (U.S.) is currently the leading issuer of individual variable annuity contracts in the United States and a significant issuer of fixed annuity contracts. MFS is the wholesale distributor of Sun Life (U.S.)'s annuity policies to stock brokerage firms and insurance broker-dealers. This statement addresses a portion of the President's tax reform proposal of deep concern to Sun Life (U.S.) and MFS: the proposal to tax annuity contractholders currently on the "inside build-up" credited under deferred annuity policies.[2] The statement also addresses the House Ways and Means Committee proposal to place a cap on annuity investments and to raise and extend the penalty on early withdrawals.

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[1] Sun Life (U.S.) and MFS are referred to collectively herein as "Sun Life (U.S.)."

[2] The President's proposal would not affect the tax treatment of inside build-up credited under qualified annuity contracts, *i.e.*, annuities held by qualified pension plans and IRAs. This statement therefore addresses the proposal insofar as it relates to nonqualified annuities.

Under Federal income tax law for over seventy years, income credited to a deferred annuity contract ("inside build-up") is not taxed to the contractholder prior to distribution. The President would reverse this long-standing policy by taxing the holder of a fixed annuity contract currently on the excess of the yearly increase in contract cash value over premiums paid. Similarly, the holder of a variable annuity contract would be taxed on his pro rata share of the income of the separate account underlying the contract.

The proposal states that the taxation of inside build-up on deferred annuity contracts would help to ensure a "level playing field" among various financial institutions, providing equivalent tax treatment for deferred annuities and short-term investment vehicles. It adds that annuities are purchased primarily by wealthy individuals, and that current taxation thereby would eliminate a bias in favor of high-income taxpayers.

Sun Life (U.S.) feels that this proposal is ill-conceived and unwise for a variety of reasons:

- Taxation of inside build-up would discourage individuals from purchasing annuities and thereby from providing for their own retirement security. Contrary to the President's suggestion, this burden would fall not on wealthy individuals but on the middle class: the average cash value of a Sun Life (U.S.) annuity contract -- including earnings as well as premiums invested -- is under $20,000. Middle-income taxpayers are the very individuals who should be encouraged to provide for their own retirement.

-- Congress has revised the taxation of annuity contracts twice in the last three years to ensure that they are in fact used as long-term retirement planning vehicles. The more recent amendments -- enacted just last year -- were accompanied by instructions to Treasury to conduct a five-year study to determine the effectiveness of the changes. Further changes to the taxation of annuities at this time are certainly premature and, we believe, unnecessary. Constant change -- and the threat of additional change -- inhibits annuity sales and places an unnecessary administrative burden on the issuing company.

-- Taxation of inside build-up would not in fact result in a "level playing field." Deferred annuities differ from short-term investment vehicles in both function and design: short-term investments are used to provide temporary investment income, while annuities -- with their guarantee of a life-long income stream -- are an ideal vehicle for long-range retirement planning.

- Equalizing the tax treatment of various investment products cannot alone level the field: disparate government regulation of life insurance companies and other financial institutions would continue to tilt the "playing field."
- Life insurance companies are a major long-term source of investment capital. Elimination of tax-deferred inside build-up would discourage investment in annuities and thereby would reduce significantly this important capital pool.

1. Deferred taxation of inside build-up encourages individual saving for retirement.

Individual saving for post-retirement years is crucial to the welfare of our society. The Social Security system provides a floor of retirement income, but cannot adequately provide for all post-retirement needs. Pension plans are a source of additional help, but often are not alone sufficient and are not available to all individuals. IRAs provide meaningful support only if the individual can make a contribution each working year, an impossible task for many middle class families that seek to purchase a home and raise and educate their children.

A deferred annuity is ideally suited for retirement planning because it is a flexible instrument that permits an individual in later years -- after he has met his family's heaviest financial obligations -- to set aside an amount that will provide guaranteed retirement income. Yet the President's proposal would discourage annuity purchases -- and thereby thwart effective retirement planning -- by taxing an annuity contractholder before he has received the funds to pay the tax.

Sun Life (U.S.)'s experience suggests that the adverse impact of such a tax would fall not on the wealthy -- as the President's proposal suggests -- but on the middle class. Annuity policies are not retirement vehicles of the rich: the average cash value of a Sun Life (U.S.) annuity is under $20,000. Wealthy individuals are less likely to be concerned about providing for their retirement and are more likely to invest their money in other tax-favored investments, such as tax-exempt bonds.

The government should encourage those who are able to provide for their retirement. The proposed taxation of inside build-up threatens to shift that cost back to the government or otherwise leave retirement needs unmet. The tax cost of the existing incentive to provide for one's retirement is minimal when compared to the potential cost of asking the government to expand Social Security benefits or otherwise to provide retirement security to private individuals through public means.[1]

In fact, the tax benefit now afforded to deferred annuities has been overstated. Unlike IRA contributions, premiums paid to purchase annuities are not deductible. Moreover, not one dollar of earnings credited under an annuity contract escapes taxation: in all cases earnings are taxed when distributed to the contractholder or his beneficiary. Indeed, annuity contracts actually operate to transform equity portfolio earnings that would be taxed at capital gains rates into ordinary income when distributed to the annuity contractholder.

Moreover, the President's proposal is irreconcilable with the fundamental principle of income taxation that tax is not levied until income is actually or constructively received, _i.e._, until such time as the income can be received without giving up substantial rights and benefits. Inside build-up is not constructively received because an annuity contractholder would have to surrender the contract and thereby forfeit substantial rights and benefits, such as his right to a guaranteed future income stream, in order to receive the contract earnings.

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[1] The President's proposal suggests that taxation of inside build-up on annuities would raise $1 billion through 1990. This revenue estimate assumes -- contrary to reason -- that individuals will continue to purchase annuities if the build-up were taxed. In fact, of course, the sale of annuities would decline drastically if the proposal were enacted, and hence any increase in revenue would be negligible at best.

Ironically, the President's proposal recognizes in other circumstances the principle that no tax is levied until funds are constructively received. For example, no tax is levied on the appreciation in the value of a home until the home is sold. Like a home -- and unlike a bank certificate of deposit -- an annuity contract is more than a mere investment from which the taxpayer periodically extracts the accumulated income: as a home provides needed shelter, an annuity contract provides security for the future. Like a homeowner -- and unlike the owner of a short-term investment vehicle -- the annuity contractholder has locked up his assets to provide for his essential needs.

2. Congress has addressed the taxation of annuities twice in the last three years. Further consideration at this time is unwarranted and unnecessary.

The above discussion demonstrates that annuities serve an important function as effective retirement planning vehicles. Recent Congressional action ensures that annuity contracts will be so used, and will not be purchased merely for short-term investment. In the Tax Equity and Fiscal Responsibility Act of 1982, Congress imposed a five percent penalty on most early withdrawals from an annuity contract, and provided that partial surrenders or cash withdrawals prior to the annuity starting date are deemed to come first from taxable income accumulated under the contract. Further, loans against the contract are treated as withdrawals, subject to the income-first rule and the five percent penalty. In the Tax Reform Act of 1984, as part of a comprehensive reform of life insurance company and product taxation, Congress expanded the scope of the five percent penalty and required an annuity contract to provide for distribution within a specified period after the contractholder's death. The pending 1984 Technical Corrections Act would expand this distribution rule to cover transfers by gift as well as by reason of death.

In making these changes, Congressional committees, in the hearings leading up to the 1984 Act, considered and rejected a proposal to tax inside build-up, finding this inconsistent with the need to foster effective retirement planning. This conclusion followed a similar rejection of President Carter's inside build-up proposal in 1978. Yet, less than a year after the passage of the 1984 Act, the President has resurrected this proposal for yet a third time. Such constant change, uncertainty and reconsideration undermine policyholder confidence, inhibit serious consideration of the annuity as a necessary retirement planning vehicle, and hence discourage retirement savings in much the same way as would the proposed tax itself. Repeated revision of the tax laws also places a significant burden on the issuing company, which must inform policyholders of the changes and then administer the contracts in accordance with the new rules.

Certainly consideration of this proposal at this time is premature. In addition to further limiting any possible use of annuities as short-term investment vehicles, the 1984 Act specifically requires the Treasury (in consultation with the Joint Committee on Taxation, the Ways and Means Committee and the Senate Finance Committee) to conduct "a full and complete study" of the taxation of life insurance. Act § 231. The Act provides that the study "shall also include an analysis of life insurance products and the taxation thereof." Id. Treasury is to submit interim reports to the Ways and Means Committee and the Senate Finance Committee on July 1, 1986, 1987 and 1988. A final report is to be submitted on January 1, 1989.

Congress mandated these studies to determine whether, in light of subsequent industry experience, the 1984 Act changes to annuity taxation were effective to restrict the use of annuities as short-term investments and to encourage their use for retirement planning. Yet the ink was scarcely dry on the 1984 Act -- with even the first of the interim reports almost two years away -- when the Treasury, in November 1984, proposed to change the taxation of annuity contracts once again. Viewed against this legislative background, reconsideration of the annuity issues at this time is simply inappropriate.

3. The proposal would not ensure a "level playing field" among comparable financial institutions and products.

The concept of a "level playing field" is meaningless in view of the differences in function and design of the various investment products. Deferred annuities permit an individual to accumulate retirement savings and to pool the risks of extended life, guaranteeing a retirement income stream that the individual (or the individual and spouse) cannot outlive. In this manner, annuities differ from short-term savings instruments, which provide temporary cash flow. It is ironic that Treasury, which, in two of the last three years, sought and received effective statutory changes to assure that annuities are used as long-term planning vehicles, now seeks to compare annuities to short-term investments, such as CDs.

As noted above, by taxing the annuity contractholder on income when he would not have the funds to pay the tax, the President's proposal would render annuities an unattractive and unuseable concept. Thus, by attempting to create a "level playing field" among unlike products, the President's proposal, if enacted, instead would remove deferred annuities from the game altogether.

Even if deferred annuity contracts were comparable to short-term investment vehicles, a change in the applicable income tax laws, without massive revision of other government regulations applicable to financial institutions, would not alone produce a "level playing field." The issuers of other investment products are not subject to the extensive regulatory restrictions imposed on life insurance companies. Unlike life insurance companies, mutual funds and security issuers are not subject to state regulation of their financial solvency. Further, unlike variable annuity issuers, issuers of debt and equity securities are not subject to the substantive restrictions of the Investment Company Act of 1940.

In the case of banks, state financial regulation does not restrict the entity's ability to grow and compete to the same extent that it does insurance companies. A bank's surplus is not reduced when it sells a certificate of deposit. In contrast, under state reserving laws, an insurance company selling an annuity policy actually must set up reserves greater than the net premiums received. Thus, each annuity sale reduces surplus. As a result, unlike a bank, an insurance company must, at some point, curtail sales in order to comply with state regulation.

Further, banks do not face the comprehensive product and market regulation that confront insurance companies. Federal securities laws are inapplicable to bank products. In addition, banks receive government assistance, such as FDIC insurance and low interest loans at the Federal Reserve discount window, that has no parallel in the insurance industry. Banks -- with their storefront offices and extensive branching system -- also enjoy superior customer access.

In short, insurance companies face a complex and comprehensive regulatory scheme that places them at a competitive disadvantage relative to other financial institutions. Even under current law, the insurance industry's share of savings dollars is declining. Unless Congress is prepared to reform and conform the laws regulating financial institutions, it will not be possible to achieve a "level playing field." The President's proposal to tax the inside build-up on deferred annuity contracts, if enacted apart from such reform, will only further tilt the playing field away from an industry already suffering under severe regulatory disabilities.

4. Taxation of the inside build-up on deferred annuities would inhibit necessary capital growth.

Life insurance companies are a major long-term source of investment capital that is vital to economic growth.[1/] Deferred annuity contracts represent a long-term commitment of funds to the insurance company by the contractholder. This commitment assures that the funds will be available as a capital source for many years. Taxation of the "inside build-up" on deferred annuity contracts, by discouraging, and perhaps eliminating, investment in these contracts, will have

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[1/] In 1983, life insurance ranked third among private domestic institutional sources of funds, supplying eight percent of the total funds flowing into financial markets. American Council of Life Insurance, 1984 Life Insurance Fact Book 67.

a deleterious effect on the long-term availability of investment funds. Funds channeled away from deferred annuity contracts will either be spent, in which case they will be completely unavailable for economic growth, or, in the best case, invested in short-term instruments, in which case they may not be available to support future capital needs.

5. The Joint Committee Proposal for Annuity Taxation.

On September 26, the Staff of the Joint Committee on Taxation released an "option paper", to serve as the basis for the House Ways and Means Committee markup of a tax reform bill. Joint Committee on Taxation, Summary of Tax Reform Option for Consideration by the Committee on Ways and Means (September 26, 1985) ("JCT Proposal"). The JCT Proposal suggests three changes to the taxation of annuity policyholders: (1) the inside build-up on annuity policies would be subject to immediate taxation to the extent that the build-up relates to an aggregate annuity investment by an individual policyholder in excess to $100,000; (2) the penalty on early withdrawals would be increased from 5% to 15%; and (3) the penalty exception for withdrawals made over a five-year period would be eliminated. JCT Proposal at 33.

For the reasons set out below, Sun Life and MFS oppose these changes.

a. 15% Withdrawal Penalty and Repeal of the Five-Year Exception.

Under current law, withdrawals from an annuity contract prior to age 59½ (not attributable to death or disability) are subject to a penalty tax equal to 5% of the portion of the withdrawal includible in income. There is an exception from this penalty for a withdrawal that is one of a series of substantially equal periodic payments made over a five-year period. The JCT Proposal would increase the withdrawal penalty to 15% and eliminate the five-year withdrawal exception.

As noted above, further revision to the tax treatment of annuity policies now is unwarranted. The Treasury has not yet had time to fulfill last year's Congressional charge to determine whether the extensive legislative changes in this area over the past three years are inadequate to insure that annuities will be used as retirement savings vehicles. Without any evidence that further changes are warranted, the JCT Proposal would once again impose on annuity issuers, including Sun Life, the considerable expense and dislocation of redesigning their products, reeducating their sales forces and reprograming their accounting procedures to conform with the new law.

The proposed changes are especially unfair since the available evidence suggests that annuity policyholders currently do not incur the 5% penalty or avail themselves of the five-year payout exception. The existing penalty provisions thus effectively discourage short-term investment in annuity contracts without necessarily discouraging their purchase due to the policyholder's ability to meet later financial emergencies or other unanticipated needs. Further increases in penalties certainly would discourage annuity investment, a result inconsistent with the recognized need to encourage individuals -- especially young individuals -- to provide for their own retirement.

The elimination of the five-year withdrawal exception is especially unjustifiable. That exception does not encourage the use of annuities as short-term investment vehicles. It is a contradiction in terms to suggest that a short-term investor would commit his funds to the vagaries of the financial markets for a five-year period. The five-year exception provides assurance to the policyholder who is investing for retirement that the annuity can provide some support prior to age 59½ in the event of an unforeseen emergency. The exception is thus meaningful only to the investor who is not seeking a temporary parking place for his funds. Elimination of the five-year exception would remove this comfort and hence would discourage the initial contract purchase. Ironically, this proposal, which purports to encourage the use of annuities for retirement purposes, would have exactly the opposite effect.

The proposed increase in the penalty rate to 15% is intended to create parity with qualified plans. This analysis ignores the fact that, in addition to the tax penalty, premature withdrawals from annuity contracts are normally subject to a surrender charge imposed by the issuing company. Thus, the true "penalty" on premature withdrawal under current law is often in excess of 10%. The JCT Proposal would increase this to more than 20% in many cases.

Moreover, the analogy to qualified plans is inapposite. Contributions to qualified plans are currently deductible. This deductibility enhances the deferral benefit, as more dollars build up tax deferred. This increased benefit more than compensates for the fact that withdrawals are fully taxable. Such is not the case for nonqualified annuities.

In addition, withdrawals are subject to immediate tax to the extent of income in the contract. The "bunching" of several year's earnings often results in taxation at a higher marginal rate than that applicable to each year's income alone. This further discourages premature withdrawals. An additional 15% penalty thus would place an unreasonable and unnecessary burden upon a policyholder who, because of an unforeseen event, needs access to his funds.

In sum, the Joint Committee Proposal would further discourage annuity purchases at a time when the attractiveness of annuity contracts has been undercut by a plethora of recent legislative and administrative changes in tax treatment. These recent changes adequately assure that annuities will be used for legitimate retirement planning purposes and not as short-term investment vehicles. In these circumstances the purchase of annuities should be encouraged, not further discouraged.

b. $100,000 Cap on Annuity Purchases.

The Joint Committee has proposed that inside build-up on annuity policies be subject to immediate taxation to the extent that the earnings relate to an aggregate annuity investment by an individual taxpayer in excess of $100,000.

A $100,000 limitation on annuity investment is far too low to permit an individual to provide more than minimal support for his retirement. For example, in a twenty-year savings program an individual would be limited to an average investment of no more than $5,000 a year. Even in a relatively stable economic environment, such a small sum is insufficient to provide retirement security. It would be wholly inadequate in a more inflationary climate. A limitation that hampers effective retirement planning is antithetical to the very purpose of an annuity policy.

The proposed cap would also impose an unnecessary penalty upon individuals who rely upon annuities as a means of support. For instance, a widow might well choose to invest a $200,000 life insurance benefit in an annuity to provide lifetime payments. Taxation of half of the build-up in such a case would be inappropriate.

Further, a cap presents severe administrative difficulties. The cap could be administered in either of two ways. The first would require each taxpayer to monitor his own annuity purchases, computing the tax due when his aggregate investment exceeds $100,000. The complexity of this determination and calculation would significantly undercut the enforceability of the provision.

Alternatively, each issuing insurance company would be required to provide information to its policyholders and the IRS, reflecting the policyholder's investment in the contract and the earnings credited thereunder. This would impose a significant administrative burden not only on the companies, but on the IRS, which must process the forms received. Indeed, the administrative effort conceivably could cost more than the meager revenue to be generated by the Proposal.

Other administrative problems are readily apparent. For instance, it is uncertain how the taxable build-up is to be computed where an individual exceeds the limitation. Is the taxpayer taxed on the earnings generated by the most recent dollars invested (to the extent these dollars raise the aggregate investment above $100,000)? Or will the tax be levied on a _pro_ _rata_ portion of all annuity build-up?

The application of the cap where the policyholder withdraws from or borrows against the policy is also unclear. The possibility of withdrawals followed by additional investments, or of borrowings (which are treated as withdrawals) followed by repayments, raises the prospect of a policyholder crossing over the $100,000 threshold and then falling back several times throughout the year. It is unclear how the investment in the policy is to be measured in such a case. Moreover, if in this case the taxpayer is deemed to have exceeded the limitation by some amount, it is unclear how the taxable earnings on the portion of the investment in excess of $100,000 for part of the year can be measured.

The cap poses technical problems as well. For instance, it is unclear how the cap would apply where a husband and wife purchase a joint and survivor annuity.

Finally, the Proposal's effective date is defective. The Proposal would count annuity investments made prior to the effective date against the $100,000 limitation. Thus, a policyholder that had purchased a $50,000 annuity last year could invest only another $50,000 in an annuity policy after enactment. Such retroactive application is even more onerous than the Administration proposal that the inside build-up provisions not apply prior to the date of Committee action, and, more important, contravenes the joint statement of Representative Rostenkowski and the Chairman of this Committee that the inside build-up provisions will not be applied retroactively. *Joint Statement by House Ways and Means Committee Chairman Dan Rostenkowski and Senate Finance Committee Chairman Bob Packwood on Effective Dates of Potential Tax Reform Legislation* (March 15, 1985). Accordingly, if adopted, the $100,000 cap should be measured only by reference to investments made after the effective date.